No. 92-____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

BANCO ESPANOL DE CREDITO, BANESTO BANKING CORPORATION, BANCO TOTTA & ACORES, GIROZENTRALE UND BANK DER OSTERREICHISCHEN SPARKASSEN AG, HARMONY GOLD LTD. HONG KONG, INTERNATIONAL COMMERCIAL BANK OF CHINA, MONROE BANK & TRUST, PHELPS DODGE CORPORATION, and STATE STREET BANK & TRUST COMPANY, as Master Trustee for the Retirement Plans of Atlantic Richfield Company and certain of its subsidiaries,

Petitioners,

—against—

SECURITY PACIFIC NATIONAL BANK and
SECURITY PACIFIC MERCHANT BANK,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Petitioners are purchasers of "loan notes", short-term debt instruments invented by banks during the mid-1980's to compete directly with commercial paper, a recognized "security." Banks vested loan notes with the same economic attributes as commercial paper, and mass-marketed loan notes to the same institutional investors who purchase commercial paper in a manner that mirrors the distribution of commercial paper. The question presented for review, which divided a panel of the Second Circuit, is:

> Whether loan notes, like commercial paper, should be held to be "securities" under the federal securities laws?

LIST OF PARTIES AND RULE 29.1 STATEMENT

Each of the parties identified in the caption to this petition participated in the proceedings before the court of appeals. The following parties participated as plaintiffs-appellants before the court of appeals but are not parties to this petition: Saudi American Bank and The Hachijuni Bank, Ltd. In addition, at the request of the court of appeals, the Securities and Exchange Commission participated as *amicus curiae* in the proceedings before that court.

Information responsive to Rule 29.1 of the Court is provided in the Appendix to this petition at 55a.

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Petitioners,

—against—

SECURITY PACIFIC NATIONAL BANK and
SECURITY PACIFIC MERCHANT BANK,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners respectfully pray that a writ of *certiorari* issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on June 24, 1992, as amended on September 8, 1992.

OPINIONS BELOW

The opinion, as amended, of the Court of Appeals for the Second Circuit is reported at 973 F.2d 51 (2d Cir. 1992) (Altimari, J.; Oakes, C.J., dissenting), and is reprinted in the Appendix to this petition at 1a. The opinion of the District Court for the Southern District of New York (Pollack, J.) is reported at 763 F. Supp. 36 (S.D.N.Y. 1991), and is reprinted in the Appendix at 24a.

JURISDICTION

The jurisdiction of this Court to review the judgment of the court of appeals entered on June 24, 1992 is invoked under 28 U.S.C. § 1254(1). The petition is timely filed within 90 days of the court of appeals' August 27, 1992 denial of petitioners' Petition for Rehearing and Suggestion for Rehearing In Banc. (44a).

STATUTE INVOLVED

This case involves the interpretation of 15 U.S.C. § 77b(1), which provides that:

When used in this subchapter, unless the context otherwise requires—

> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

STATEMENT OF THE CASE

This petition arises out of Security Pacific's sales to petitioners of "loan notes" between April 10 and June 9, 1989.

Loan notes are short-term debt instruments invented by banks during the mid-1980's to compete with short-term commercial paper, which investment banks were selling at a lower cost to the issuer than traditional bank financing. (12a, 13a, 15a). To recapture the business they lost, banks vested loan notes with the same economic attributes as commercial paper, and mass-marketed loan notes to institutional investors in a manner that mirrors the distribution of commercial paper. Investors quickly accepted loan notes as a fungible alternative to commercial paper, and sales of loan notes are now estimated to exceed $100 billion a year. (15a).

Over the vehement protests of then-Chief Judge Oakes and the Securities and Exchange Commission (the "Commission"), whose brief *amicus curiae* was solicited by the court below and then ignored by the majority ("SEC Brief"), a divided Second Circuit panel held that loan notes are not securities. Judge Oakes did not mince words in dissent:

> [T]he majority opinion misreads the facts, makes bad banking law and bad securities law, and stands on its head the law of this Circuit and of the Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

(11a). Without intervention by this Court, the burgeoning loan note market will escape the antifraud protections of the federal securities laws.

In its statement to the Second Circuit urging rehearing, the Commission expressed even greater concern that

> the majority opinion could do significant harm not only to the regulation of the large loan note market (which is estimated to exceed $100 billion annually), but to the regulation of the sale of notes in general.

Statement of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Appellants' Petition for Rehearing and Suggestion for Rehearing En Banc at 2 ("SEC Rehearing Statement"). The significance of this case thus extends far beyond loan notes; as the Commission warns, the majority opinion "endorses sweeping principles that could read out from coverage of the federal securities laws sales of debt to persons who plainly require the protection of those laws." *Id.*

A. Loan Notes Were Designed As An Alternative To Commercial Paper.

During the 1980's, corporations turned increasingly to commercial paper programs to fill short-term credit needs because commercial paper can be issued at a lower cost to corporations than bank loans. (13a). To recapture that lucrative market from commercial paper underwriters, major commercial banks devised and began to market loan notes as an alternative to commercial paper. (15a).

Banks generate loan notes the same way that underwriters generate commercial paper: they acquire a large amount of a corporate issuer's short-term, unsecured debt and immediately resell the acquired debt in individual pieces, *i.e.*, "loan notes", to institutional investors. (13a). Like commercial paper, loan notes are unsecured short-term obligations (typically 30 days) in fixed denominations (usually $1 million). (13a, 29a).

B. Loan Notes Are Sold In The Identical Manner As Securities.

As the Commission and Judge Oakes recognized, the sale of loan notes mirrors the distribution of commercial paper and, indeed, is indistinguishable from typical securities distributions.

> a. Security Pacific promotes its "Commercial Loan Notes" in brochures, advertising them as a more profitable alternative to "*their commercial paper equivalents*." (emphasis added). The brochures refer repeatedly to the loan notes as "investments", and tout the "liquidity" that

would be provided to "investors" by the bank's "trading and distribution capabilities." (11a-13a).

b. Aggressive telephone marketing is used by the loan note sales force (called "traders" by Security Pacific). (8a). Investors are called frequently, as often as 15 times a day. Sales people make "cold calls" to names in business directories and bank customer lists, seeking to lure new investors. (14a). Consistent with securities industry practice, all such telephone calls are tape-recorded.

c. During these rapid-fire telephone sales pitches, traders offer investors loan notes of various corporate "issuers" in different principal amounts and maturities. (19a). Security Pacific and investors may negotiate the interest rate that the notes will yield. Investors then decide quickly, usually within minutes, whether to invest in a particular note. Security Pacific earns its profit based on the spread between the interest rate it sets with the issuer and the interest rate it negotiates with investors on the corresponding loan notes.

d. The loan note program is part of the bank's "Global Trading" department. Loan note traders operate from a trading desk set up on the same trading floor from which other Security Pacific traders deal in government-backed instruments, foreign currencies, and other securities. (13a). Traders record loan note transactions on "tickets" and consolidate trades into a "trade blotter." Issuers in need of short-term cash are tracked constantly on nearby blackboards.

e. Security Pacific presses this sales campaign to the broad spectrum of institutional investors—not just banks—including corporations, insurance companies, pension funds, mutual funds and money managers. Its wide-ranging search for investors is successful; a majority of the investors in loan notes sold by Security Pacific are non-banking institutions. (13a).

In all significant respects, therefore, Security Pacific's loan note program functions exactly like a securities underwriting

operation: The corporate issuer issues short-term debt. The bank, acting as underwriter, sets an interest rate as a function of the rate at which it expects to be able profitably to sell loan notes to investors. The bank then resells the debt to institutional investors in small pieces through aggressive telemarketing.

C. Loan Notes Have Nothing To Do With Traditional Loan Participations.

In an effort to escape the reach of the federal securities laws, Security Pacific pretends that it operates the loan note program merely as a courtesy to its corporate customers whose credit needs exceed the bank's ability to lend. And so it claims that the loan notes it sells investors are really "participations" in commercial "loans" to those customers. Security Pacific similarly characterizes the $100 billion-plus loan note market as a "computerized loan participation program", the product of "modern technology."

Neither the Commission nor Judge Oakes was deceived by Security Pacific's attempt to disguise loan notes as traditional loan participations. As both recognized, loan note transactions bear none of the underlying characteristics of loan participations.

1. Security Pacific does not act like a lead lender to purported "participants."

In a traditional loan participation, the lead lender provides a potential participant with credit information about the borrower, as well as the underlying loan documents. Loan officers from both banks then negotiate the terms of the participation. (12a). That entire process is absent in loan note transactions.

First, loan note investors are not provided with the results of Security Pacific's credit investigation. (12a, 18a, 19a). Nor can they gain access to such information. The Master Participation Agreement ("MPA") signed by investors expressly prohibits them even from identifying themselves to issuers.

Further, little underlying loan documentation exists. Integrated Resources, Inc. ("Integrated"), for example, the corporate issuer of the loan notes sold to petitioners, had been a loan note issuer for more than a year before the sales to petitioners; its involvement in the program, however, was not documented even by a loan or a credit agreement.

Finally, no loan or credit personnel are involved in loan note transactions. Security Pacific's traders sell loan notes from a trading desk situated in a large "boiler room." (13a). The majority of Security Pacific's investors, as non-banking institutions, have no lending departments or credit function. Even when loan notes are sold to banks, the investing banks act not through their lending departments, but through their separate investment or trading divisions. (11a).

2. Security Pacific does not act like a commercial lender to issuers.

A commercial lender typically negotiates with its customer to receive a spread exceeding its cost of funds. The lender may then solicit other banking institutions to participate in the loan, in order to increase credit lines available to its customer or to reduce its own exposure.

By contrast, Security Pacific and the loan note issuer negotiate a principal amount and a fixed interest rate based on rates prevailing in the commercial paper market. Security Pacific does not commit to advance funds to the issuer until it is convinced that it profitably can sell to investors loan notes in that principal amount. Security Pacific always intends to transfer to investors the entire credit risk on the underlying loan; the bank's own funds are at risk only for the limited time, usually a few hours, during which it holds inventory that it has not yet sold to investors. (8a). On certain sales to petitioners, Security Pacific eliminated even that risk, refusing to wire funds that it committed to advance to Integrated until it had petitioners' corresponding loan note funds in hand.[1] (*Id.*)

1 The fact that some issuers in Security Pacific's program are not even existing customers of the bank further refutes Security Pacific's claim that it sells loan notes simply to "increase lines of credit" to valued customers.

3. Security Pacific makes an underwriter's profit selling loan notes.

Like underwriters of commercial paper, Security Pacific amasses profits through the high-volume telephone distribution of short-term debt investments. As far back as 1988, in fact, Security Pacific's prolific traders were already executing more than 15,000 loan note transactions annually, and generating about $5 million in revenues. These figures are particularly impressive because, like commercial paper underwriters, Security Pacific works at razor-thin margins as slim as $100 per trade. Tellingly, Security Pacific accounts internally for loan note profits on a daily basis, characterizing those profits not as interest income but as "trading" profits.

In short, the actual operation of the loan note market confirms without doubt that it has nothing to do with commercial lending or loan participations, and everything in common with commercial paper underwriting.

D. The Proceedings Below

During the same time that Security Pacific was stepping up sales to petitioners of Integrated loan notes, Security Pacific concealed from petitioners material, non-public information about Integrated's deteriorating financial condition. (5a). That same information had caused the bank to reject Integrated's request for additional credit and to retrench its existing credit exposure on Integrated. (*Id.*) None of this information was accessible to plaintiffs.

On June 12, 1989, Integrated declared a moratorium on all debt obligations, and later filed a petition in bankruptcy. (*Id.*) As of the time of Integrated's default, nearly $100 million of Integrated loan notes sold by Security Pacific were outstanding. None of those notes have been repaid.

On April 9, 1990, petitioners filed suit against Security Pacific in the United States District Court for the Southern District of New York, alleging that Security Pacific violated, among other things, Section 12(2) of the Securities Act of 1933

when it concealed non-public information about Integrated. (6a).

On May 3, 1991, the district court granted Security Pacific's motion for summary judgment on petitioners' securities claims, ruling that loan notes are "private commercial loan contracts" and not securities. (24a).

The Second Circuit heard argument on October 28, 1991. A few days later, it solicited the views of the Commission on the "principal question involved" on appeal:

> [W]hether the short-term debt instruments sold to investors, including banks, corporations, trustees for retirement plans, and others, by Security Pacific National Bank are "securities" within Section 12(2) of the Securities Act of 1933.

In a 47-page brief reflecting meticulous review of the record and industry literature, the Commission concluded that under this Court's test in *Reves v. Ernst & Young*, as well as under applicable Second Circuit precedent, petitioners' "loan notes were purchased in an investment transaction and are securities." SEC Brief at 2.

On June 24, 1992, a divided Second Circuit panel affirmed the district court's ruling. (1a). Without even acknowledging the Commission's brief or views, the majority opinion deferred to the district court's conclusion that loan notes are not securities. Judge Oakes dissented in a strongly-worded opinion which deplored the majority's failure to confront the record facts or the Commission's brief. Like the Commission, Chief Judge Oakes concluded that, as a matter of economic reality, "loan notes were purchased in investment transactions and are securities." (11a).

On July 8, 1992, petitioners filed a petition for rehearing of the appeal, and suggested rehearing in banc. On July 9, the Commission filed a statement *amicus curiae* in support of that petition. The court denied the rehearing petition on August 27, again over the dissent of Chief Judge Oakes. (44a).

On September 8, the majority amended its opinion. In an apparent effort to discourage intervention by this Court, the panel majority explained that its opinion was limited to the loan notes marketed to petitioners. (23a). The majority did not suggest, however, that the loan note sales to petitioners are in any way atypical of the billions of dollars in loan note sales effected every year.

REASONS FOR GRANTING THE WRIT

In *Reves v. Ernst & Young*, 494 U.S. 56 (1990), this Court set forth a four-part test for determining when a "note" is a "security." Recognizing "the virtually limitless scope of human ingenuity" (494 U.S. at 61), *Reves* advocates a flexible approach "founded on economic reality" (*id.* at 63 n.2) in order to carry out "Congress' purpose in enacting the securities laws to regulate *investments*, in whatever form they are made and by whatever name they are called." 494 U.S. at 61 (emphasis in original).

The economic reality of loan notes—their origin, design, method of sale, and the actual operation of the loan note program—compels the conclusion that loan notes are investment securities. Indeed, that is precisely what Security Pacific's promotional materials and sales tactics tell investors they are buying.

The writ therefore is necessary because the majority opinion leaves a giant and growing sector of the securities market completely outside the antifraud protections of the securities laws.

The writ also should issue because the panel majority distorts beyond recognition the four *Reves* factors and the reasoning that informs them. If not corrected, the majority decision may undermine the effective regulation of all investment notes. In endorsing rehearing of the panel's decision, the Commission stated those concerns bluntly:

> the majority opinion could do significant harm not only to the regulation of the large loan note market . . . but to

> the regulation of the sale of notes in general. The opinion endorses sweeping principles that could read out from coverage of the federal securities laws sales of debt to persons who plainly require the protection of those laws.

SEC Rehearing Statement at 2. Because the Second Circuit has struck out so definitively in the wrong direction in its application of *Reves*, immediate intervention from this Court is necessary before reliance on the majority opinion creates further disorder in the debt markets.

I. The Majority Opinion Leaves A Large And Growing Sector Of The Securities Market Outside The Antifraud Provisions.

Loan notes are hardly some idiosyncratic instrument unique to the transactions at issue here. By concluding that loan notes are not securities, the Second Circuit has exempted from the antifraud provisions an important and growing sector of the short-term debt market.[2]

The majority also nurtures the very evil this Court warned against in *Reves*: the skillful design by savvy marketers of investments "to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition." 494 U.S. at 63 n.2. Security Pacific makes its escape here by invoking the loose form of a traditional loan participation. "An approach founded in economic reality", however, reveals that Security Pacific has created and is aggressively marketing a new investment security closely analogous to commercial paper. Examining that economic reality, the Commission concluded that loan notes clearly are securities, and that "whatever surface similarities exist between the

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2 Although the majority entirely exempts the loan note market from the scope of the securities laws, such exemption is not necessary to free that market from registration requirements. As the Commission has opined, "[s]ales of loan notes likely can be structured in such a way to avoid the need for securities registration." SEC Brief at 6.

loan note program and traditional loan participations, these loan notes are in critical respects very different." SEC Brief at 4. Judge Oakes agreed, and took sharp issue with the majority's refusal to confront the record facts or the Commission's brief.

The impact of the majority opinion, moreover, is hardly limited to loan notes. As the Commission understood, the majority opinion "suggests that so long as a note originally reflects a commercial loan by a commercial lender . . . its resale to others in 'discrete portions' cannot be a securities transaction." SEC Rehearing Statement at 3. Such a rule tears "open a large loophole in the coverage of the federal securities laws." *Id.* Banks need only advance funds nominally designated "commercial loans", and could then immediately resell even to individual investors pieces of that advance in various innovative forms, without the portions being considered securities. *Id.*

The Second Circuit's amendment of its decision renders this aspect of its holding even more problematic. Rather than revisiting its missapplication of *Reves*, the amendment merely notes that this case does not involve sales to the "general public", but rather to entities "with the capacity to acquire information about the debtor." (22a).

Such a distinction, however—which is nowhere suggested in *Reves*—is utterly without basis in the federal securities laws, whose antifraud provisions apply equally to the naive and the sophisticated investor. *See Superintendent of Ins. v. Bankers Life Casualty Co.*, 404 U.S. 10 (1971) (large institutions are entitled to same antifraud protection as individual investors). It also invites additional litigation by marketers of investments trying to defeat securities laws claims on the basis of purchasers' subjective "capacities to acquire information." Finally, that distinction is ill-drawn with respect to loan note investors who undeniably lack access to the vital, non-public credit information available to commercial lenders.

The amendment also does little to lessen the decision's impact by purporting to limit the decision to the instruments "as marketed in this case." (23a). By definition, every decision

is limited to its facts; that is why courts draw fact-based distinctions when meaningful fact differences exist.

Moreover, the amendment points to no fact differences that would make its purported "limitation" meaningful. The panel majority does not suggest that Security Pacific's loan note program is in any way atypical of loan note programs industry-wide. Even if some presently-existing loan note programs do operate in ways that might marginally distinguish them from Security Pacific's, the panel majority has effectively designated Security Pacific's program as a safe harbor from the securities laws into which other loan note programs can gain safe entry merely by conforming themselves to the form of Security Pacific's program as described here.

For this reason, it also is important that this Court intervene right now. While the legal status of loan notes is a matter of first impression, the Second Circuit's decision renders additional litigation unlikely. This is because the decision encourages banks to conform their loan note programs to Security Pacific's; defrauded investors would then have little incentive to assert the same securities laws claims dismissed here by the Second Circuit.

Even if certain banks do not conform their programs, the fact that the Second Circuit is the only court to have adjudicated the status of loan notes *heightens* the need for immediate guidance. The Second Circuit is home to the nation's largest financial markets and has enjoyed a preeminent position among the circuits in matters of securities law. The Second Circuit also originated the "family resemblance" test that is the forerunner of the four-part test adopted by the *Reves* Court. Absent intervention by this Court, it is unlikely that lower courts will take issue with the Second Circuit's decision.

II. The Majority Opinion Distorts This Court's Decisions Defining Securities.

While the majority opinion is beset with factual error, this petition is directed instead at the panel majority's distortion of the *Reves* factors and of the reasoning underlying them. The

panel majority has permitted sales of debt instruments that clearly are investments, and that are totally unregulated elsewhere, to escape even the modest regulation imposed by the antifraud provisions. Absent intervention by this Court, that same distortion of *Reves* is likely to undermine the effective regulation of all investment notes.

Reves addresses a basic problem in determining when a note is security. Although the Securities Act provides that "security" includes "any note" (*see* 15 U.S.C. § 77b(1)), Congress presumably did not intend to treat all makers of notes as issuers of securities. The home buyer who signs a promissory note in connection with a mortgage loan, for example, is not understood to have created a security, nor does the mortgagee bank require securities laws protection. On the other hand, bonds, debentures, and commercial paper, although similar in form to home mortgage notes, are quintessential securities, sold in the very sort of investment context for which the Securities Act was designed. Prior to *Reves*, the Courts of Appeals were deeply divided over where to draw the line, and which notes to except from characterization as securities because "the context otherwise requires." *Id.*

The *Reves* Court resolved that debate. "[B]ecause the Securities Acts define 'security' to include 'any note'," the "family resemblance" approach begins "with a presumption that every note is a security." 494 U.S. at 65 (footnote omitted). That presumption then can be rebutted if the instrument in question bears a "*strong* family resemblance" to those commercial notes, such as consumer notes and mortgage notes, that generated exceptions in the first place to the "any note" language in the Act. *Id.* at 64 (emphasis added). The Court then listed four factors by which to gauge a possible resemblance.

As the *Reves* Court made clear, these four factors are simply another "way[ ] of formulating the same general approach" as the "investment versus commercial" test used in several circuits before *Reves*. 494 U.S. at 64. That is, each factor is carefully calibrated to assess whether the note is being marketed as an investment, or whether it is merely an adjunct to a "purely commercial or consumer transaction." 494 U.S. at 68. By fus-

ing four separate tests designed to ferret out only genuinely commercial instruments, the *Reves* Court was determined "to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition." 494 U.S. at 63 n.2.

But rather than employing the *Reves* factors to assess whether loan notes are, in economic reality, investments, the panel majority applied those factors superficially and mechanically, and disregarded completely the fundamental characteristics of loan notes and the purpose of the securities laws. In so doing, the majority has transformed *Reves* into a roadblock denying investors in even textbook investments access to federal securities laws protection. As the Commission complains,

> the panel majority construes the *Reves* factors in so broad a fashion as to read out from coverage of the securities laws sales of debt that, we believe, plainly were intended to be covered by those laws.

SEC Rehearing Statement at 3.

The panel majority's distortion of each of the *Reves* factors makes it imperative that this Court clarify immediately the proper application and reasoning of the test set out in *Reves*:

1. The panel majority's distortion of *Reves* begins with its reading of the first factor: the motivations of the parties. The *Reves* Court instructed that a note "is likely to be a security"

> [i]f the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate.

494 U.S. at 66. A note is "less sensibly described as a 'security' " if "exchanged to facilitate the purchase and sale of a minor asset or consumer good" or some similar "commercial or consumer purpose." *Id.* To illustrate a genuine non-security, the *Reves* Court cites the shares of "stock" in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), which had

"none of the characteristics 'that in our commercial world fall within the ordinary concept of a security' ", but were merely vouchers that carried rights to subsidized low-income housing. 421 U.S. at 851.

The panel majority held that the "overall motivation" here was "commercial" because "Security Pacific was motivated by a desire to increase lines of credit to Integrated", Integrated "was motivated by a need for short-term credit at competitive rates", and purchasers "sought a short-term return on excess cash." (9a).

The motivations described by the panel majority, however, are the paradigmatic motivations of a securities distribution, such as a commercial paper underwriting, and are nothing like the overtly commercial motivations found in *Forman*. The "short-term return on excess cash"—*i.e.*, interest—sought by purchasers is precisely the "profit" motivation which *Reves* said *defines* a security. *See Reves*, 494 U.S. at 68 n.4 (" 'profit' in the context of notes . . . undoubtedly includes interest").[3] Integrated's interest to obtain "short-term credit at competitive rates" is similarly the classic motivation of commercial paper issuers. Finally, even if Security Pacific intended in part to increase lines of credit to Integrated, the bank functioned not as a commercial lender but as a securities underwriter, generating profits by raising funds for issuers and retaining no credit risk for itself. As the Commission aptly points out,

> the same motivations that were present here underlie virtually all sales of short-term corporate debt, including transactions in well-established securities such as commercial paper. Under the majority's approach, any notes given by a corporation seeking short-term cash could be

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3 As noted, most investors in Security Pacific loan notes are *non*-lending institutions; even those investors who are also in the business of lending purchase loan notes through their treasury, not their lending, functions. (11a). As both Judge Oakes and the Commission concluded, petitioners, almost by definition, "were motivated not by the commercial purpose of operating of a lending business . . . but were motivated by an investment purpose." 11a; SEC Rehearing Statement at 4.

> *deemed to be a commercial* transaction, rather than a securities transaction.

SEC Rehearing Statement at 4.[4]

2. The second *Reves* factor examines the "plan of distribution of the instrument" in order to determine whether there is "common trading for speculation or investment." 464 U.S. at 66.

The majority concluded that there was no "common trading" of loan notes because "the plan of distribution was a limited solicitation to sophisticated" investors. (9a). In the amendment of its decision, the majority suggested that "common trading" is also absent because loan notes are not secondarily traded. (22a).

Both of the panel's reasons contradict this Court's decisions. As noted, the perceived "sophistication" of the investor has nothing to do with whether there is "common trading" or whether an instrument is a security. As the Commission points out, "[n]umerous debt securities are only sold in large denominations to sophisticated institutions." SEC Rehearing Statement at 5. Indeed, "at the time the Securities Act was adopted in 1933 virtually the only purchasers of commercial paper were banks. Yet Congress made clear that commercial paper was a security entitled to the protection of the antifraud provisions of the securities laws." *Id.*[5]

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4 The result called for by the majority, as the Commission points out, is wholly at odds with courts of appeals decisions deeming sales of short-term corporate debt securities transactions. See, e.g., *SEC v. The American Board of Trade, Inc.*, 751 F.2d 529 (2d Cir. 1984). *See also Zeller v. Bogue Electric Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984); *Lawler v. Gilliam*, 569 F.2d 1283 (4th Cir. 1978); *SEC v. World Radio Mission*, 544 F.2d 535 (1st Cir. 1976).

5 Commenting on the panel majority's suggestion that large institutions are somehow not entitled to the protections of the federal securities laws, the Commission states that

> the [panel] majority appears to confuse the registration requirements of the Securities Act (which are subject to exemptions that might be available for sales to large institutional purchasers under certain cir-

The panel majority's afterthought argument that loan notes are not traded on a secondary market is refuted by *Reves* itself, where this Court made clear that the demand notes there *were* securities even though they "were not traded on an exchange", and cited numerous cases in which non-traded instruments were held to be securities. 494 U.S. at 68, citing *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *Tcherepnin v. Knight*, 389 U.S. 332 (1967). Security Pacific admittedly makes many thousands of loan notes sales each year to hundreds of investors. This Court's conclusion in *Reves* is thus fully applicable here: the notes were "offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite 'common trading' in an instrument." *Reves*, 494 U.S. at 68.[6]

3. The third *Reves* factor asks courts to gauge the "reasonable expectations of the investing public." 494 U.S. at 68. The demand notes in *Reves*, for example, were held to have encouraged "investment" expectations because "advertisements for the notes [t]here characterized them as 'investments' " and "it would be reasonable for a prospective purchaser to take the [seller] at its word." 494 U.S. at 69.

Security Pacific explicitly characterizes loan notes as "investments." The bank's brochures—*e.g.*, "Loan Notes: The Short-Term *Investment* Alternative"—tell "*investors*" to "*invest* in loan notes", compare loan note yields with those of "*comparable* commercial paper", and boast that "[o]ur traders and sales professionals work closely with *investors* in order to match their individual *investment needs*." (11a-12a, 14a;

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cumstances) and antifraud protections, which apply to all securities purchasers.

SEC Rehearing Statement at 5.

6 While an absence of secondary trading is irrelevant under *Reves*, Security Pacific actually vows in its sales literature to undertake its "best efforts" to bid on loan notes that an investor desires to sell, boasting that its ability to purchase or place the notes will provide investors sufficient liquidity even though it does "not *fully* commit to make a secondary market in loan notes." (14a-15a; emphasis added).

emphases added). Security Pacific then presses a high-volume telephonic sales campaign that mirrors the distribution of commercial paper and other investments. Indeed, Security Pacific's success in depicting loan notes as investments is precisely what has attracted to its program institutional investors who are not in the money lending business.

Ignoring the expectations of investors which Security Pacific worked hard to encourage, the panel majority concluded that purchasers have "ample notice" that loan notes are "not investments in a business enterprise" because certain—although not all—investors sign a form document entitled "Master Participation Agreement" ("MPA") before executing their first transactions. (9a). According to the majority, certain language in that form agreement should have persuaded investors that, contrary to Security Pacific's insistence that they were buying investments, they were actually participating in commercial bank loans.

Once again, the panel majority misses the point of *Reves*. This factor measures what the investing public *believes*, not what sellers insert in fine print in form documents to disclaim expectations and beliefs they themselves have fostered. Any reasonable purchaser, faced with the totality of Security Pacific's conduct, would reasonably perceive loan notes as short-term investments comparable to commercial paper—precisely what Security Pacific wanted them to think. As Judge Oakes explained,

> The bottom line is that the market closely resembles the commercial paper market which Judge Lasker once described as involving 'a brief series of telephone conversations' between buyer and seller, *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 885 (S.D.N.Y. 1976) . . . . Whatever the language of the MPAs relied upon by the majority and the district court, the language of the promotional literature repeatedly referred to "investors" and "investments."

(19a).

4. Finally, the panel majority's distortion of *Reves* is illustrated again, perhaps most vividly, by its misapplication of the fourth factor, which asks "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary." 494 U.S. at 67. As an illustration of such regulatory scheme, the *Reves* Court cites to *Marine Bank v. Weaver*, 455 U.S. 551 (1982), where investors were *fully* protected by FDIC insurance guaranteeing repayment. According to the panel majority,

> the district court noted that the Office of the Comptroller of the Currency has issued specific policy guidelines addressing the sale of loan participations. Thus, the fourth factor—the existence of another regulatory scheme—indicated that application of the securities laws was unnecessary.

(9a-10a).

As its plain language makes clear, however, the fourth *Reves* factor does not require simply "*another* regulatory scheme", but rather "another regulatory scheme that *significantly reduces the risk of the instrument*, thereby rendering application of the securities laws unnecessary." 494 U.S. at 67 (emphasis added). In fact, *no* other risk-reducing scheme applies to loan notes. The regulatory guidelines referred to by the district court, OCC Circular 181, impose *no* restrictions at all on banks, such as Security Pacific, that sell loan notes. They apply only to national banks *purchasing* loan participations, requiring them to perform for themselves the careful credit investigation required ordinarily of a commercial lender. (48a).

None of petitioners, moreover, (and only 15% of Security Pacific's customers overall) are national banks. Accordingly, no one—not the OCC, not the district court, and not the panel majority—so much as suggests that Circular 181 reduces *any* risk to loan note investors. Nor could they; the Circular requires no disclosures, provides no remedies, and offers investors' no insurance. The majority's reliance on Circular 181

to exempt loan notes from the antifraud provisions reduces *Reves*' pivotal risk-reducing factor to an absurdity by exempting instruments from the antifraud provisions if they are so much as mentioned in some irrelevant government regulation.

* * * * *

The Commission aptly summarizes the majority's evisceration of *Reves*:

> the majority opinion has overlooked all of the indicia that these transactions were securities transactions—that they were purchases of instruments marketed as investments, bought by persons acting from an investment motivation and with only the type of publicly available information commonly available to investors, and bought in sales subject to no risk-reducing scheme of regulation. In sweeping these considerations aside, the majority has issued a decision that could call into question the application of the securities laws in a wide range of debt transactions.

SEC Rehearing Statement at 7.

The writ should issue to remedy these distortions.

CONCLUSION

For the above reasons, the petition for certiorari should be granted.

Dated: November 25, 1992

Respectfully submitted,

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APPENDIX

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 358, 359—August Term 1991

(Argued: October 28, 1991 Decided: June 24, 1992)

Docket Nos. 91-7563, 91-7571

BANCO ESPANOL DE CREDITO; BANESTO BANKING CORPORATION; BANCO TOTTA & ACORES; GIROZENTRALE UND BANK DER OSTERREICHISCHEN SPARKASSEN AG; HARMONY GOLD LTD. HONG KONG; INTERNATIONAL COMMERCIAL BANK OF CHINA; MONROE BANK & TRUST; PHELPS DODGE CORPORATION; SAUDI AMERICAN BANK; STATE STREET BANK & TRUST COMPANY, as Master Trustee for the Retirement Plans of Atlantic Richfield Company and certain of its subsidiaries; HACHIJUNI BANK, LTD.,

Plaintiffs-Appellants,

—against—

SECURITY PACIFIC NATIONAL BANK;
SECURITY PACIFIC MERCHANT BANK,

Defendants-Appellees,

HACHIJUNI BANK, LTD.,

Plaintiff-Appellant,

—against—

SECURITY PACIFIC NATIONAL BANK;
SECURITY PACIFIC MERCHANT BANK,

Defendants-Appellees.

Before:

OAKES, *Chief Judge*,
FEINBERG and ALTIMARI, *Circuit Judges*.

Appeal from judgment entered in the United States District Court for the Southern District of New York (Milton Pollack, *Judge*), granting defendants' motion for summary judgment and denying plaintiffs' cross-motion for partial summary judgment in an action alleging that defendants violated federal securities laws and breached various common law duties of disclosure in their sales of short-term loan participations.

Affirmed.

Chief Judge Oakes dissents in a separate opinion.

CHARLES E. DORKEY III, New York, N.Y. (Thomas I. Sheridan III, Mark Garbowski, Richards & O'Neil, New York, N.Y., of counsel), *for Plaintiffs-Appellants Banco Espanol de Credito and Banesto Banking Corporation.*

JACK P. LEVIN, New York, N.Y. (Lawrence A. Darby III, Vivien B. Shelanski, J. Jay Lobell, Howard Darby & Levin, New York, N.Y., of counsel), *for Plaintiffs-Appellants Banco Totta & Acores, et al.*

JED S. RAKOFF, New York, N.Y. (Fried, Frank, Harris, Shriver & Jacobson; Harold G. Levison, Mudge, Rose, Guthrie, Alexander & Ferdon, New York, N.Y., of counsel), *for Defendants-Appellees Security Pacific National Bank and Security Pacific Merchant Bank.*

JOHN L. WARDEN, New York, N.Y. (H. Rodgin Cohen, Michael M. Wiseman, David A. Heiner, Jr., Sullivan & Cromwell, New York, N.Y., of counsel) filed a brief amicus curiae on behalf of The New York Clearing House Association.

JAMES R. DOTY, Washington, D.C. (Jacob H. Stillman, Eric Summergrad, Martha H. McNeely, Randall W. Quinn, Paul Gonson, Washington, D.C., of counsel) filed a brief amicus curiae on behalf of the Securities and Exchange Commission.

ALTIMARI, *Circuit Judge*:

Plaintiffs-appellants, purchasers of various "loan participations" sold by defendants-appellees Security Pacific National Bank and Security Pacific Merchant Bank (collectively "Security Pacific"), appeal from a judgment entered in the United States District Court for the Southern District of New York (Milton Pollack, *Judge*), granting summary judgment for Security Pacific and dismissing plaintiffs' complaints. In the two underlying actions, which were consolidated for appeal, plaintiffs charged that Security Pacific had withheld material infor-

mation on the financial solvency of Integrated Resources, Inc. ("Integrated") when Security Pacific sold plaintiffs portions of loan notes owed by Integrated to Security Pacific. Plaintiffs sought to rescind their purchase agreements based on an alleged violation of Section 12(2) of the 1933 Securities Act and sought damages for Security Pacific's alleged breach of various common law duties.

Plaintiffs moved for summary judgment on the securities claim and Security Pacific cross-moved for summary judgment on all claims. In granting defendants' motion for summary judgment, the district court first rejected plaintiffs' securities claim, holding that the loan participations at issue were not "securities" within the meaning of the 1933 Act, and were therefore not governed by the federal securities laws. The district court also rejected plaintiffs' common law claims, finding that Security Pacific had no duty to disclose information on Integrated's financial condition under either the terms of the loan participation agreements signed by plaintiffs or under general principles of common law.

On appeal, plaintiffs contend that the district court erred in: (1) determining that loan participations sold by Security Pacific were not securities; and (2) determining that Security Pacific owed no duty to disclose negative financial information about Integrated.

For the reasons set forth below, we affirm the judgment of the district court.

BACKGROUND

In 1988, Security Pacific extended a line of credit to Integrated permitting Integrated to obtain short-term unsecured loans from Security Pacific. Security Pacific

subsequently made a series of short-term loans to Integrated. Security Pacific sold these loans, in whole or in part, to various institutional investors at differing interest rates. The practice of selling loans to other institutions is known as "loan participation." Short-term loan participation permits a primary lender such as Security Pacific to spread its risk, while at the same time allowing a purchaser with excess cash to earn a higher return than that available on comparable money market instruments. Security Pacific, as manager of the loans, earned a fee equal to the difference between the interest paid by the debtor and the lower interest paid to the purchaser.

Security Pacific assumed no responsibility for the ability of Integrated to repay its loans. Indeed, each purchaser of loan participations was required to enter into a Master Participation Agreement ("MPA"), which contained a general disclaimer providing, in relevant part, that the purchaser "acknowledges that it has independently and without reliance upon Security [Pacific] and based upon such documents and information as the participant has deemed appropriate, made its own credit analysis."

In late 1988, Integrated began to encounter financial difficulties. In April 1989, Security Pacific refused a request by Integrated to extend further credit. Despite this refusal, Security Pacific continued to sell loan participations on Integrated's debt. Indeed, from mid-April through June 9, 1989, Security Pacific sold seventeen different loan participations to plaintiffs-appellants. Unable to obtain enough working capital, Integrated began defaulting on its loans on June 12, 1989. Integrated subsequently declared bankruptcy.

As a result of Integrated's default, two sets of investors, who had purchased the seventeen loan participations, ini-

tiated separate actions against Security Pacific in the United States District Court for the Southern District of New York. Contending that the loan participations were "securities" within the meaning of the Securities Act of 1933 ("the 1933 Act"), plaintiffs sought to rescind their purchase agreements by alleging that Security Pacific had failed to disclose to them material facts about Integrated's financial condition in violation of § 12(2) of the 1933 Act. 15 U.S.C. § 77(l)2. Plaintiffs also claimed that Security Pacific's failure to disclose constituted a breach of Security Pacific's implied and express contractual duties under its MPA's, and a breach of Security Pacific's duty to disclose material information based on superior knowledge. Based on these common law claims, plaintiffs sought to recover their investment plus unpaid interest. Plaintiffs in each of the two actions moved for partial summary judgment on the securities claim. Security Pacific cross-moved for summary judgment on all claims. The cases were consolidated for argument.

In ruling on these motions, the district court concluded that the loan participations were not "securities" within the meaning of the Securities Act of 1933, and that, therefore, plaintiffs could not assert a violation under § 12(2) of this Act. In addition, the district court held that the express disclaimer provisions in the MPA precluded plaintiffs' common law claims. Accordingly, the district court granted summary judgment to Security Pacific and dismissed the complaints. *See Banco Espanol de Credito v. Security Pacific National Bank*, 763 F. Supp. 36 (S.D.N.Y. 1991). Plaintiffs now appeal.

DISCUSSION

Summary judgment is properly granted when "there is no genuine issue as to any material fact" and "the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c); *see also Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247 (1986); *Viacom Int'l, Inc. v. Icahn*, 946 F.2d 998, 1000 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1244 (1992). We review the district court's grant of summary judgment *de novo* and resolve all ambiguities and inferences from the underlying facts in favor of the party against whom summary judgment is sought. *See, e.g., Viacom Int'l, Inc.*, 946 F.2d at 1000.

Section 2(1) of the 1933 Act provides in pertinent part:

> [U]nless the context otherwise requires—(1) the term security means any note . . . evidence of indebtedness, . . . investment contract, . . . or any certificate of interest or participation in . . . any of the foregoing.

15 U.S.C. § 77b(1). It is well-settled that certificates evidencing loans by commercial banks to their customers for use in the customers' current operations are not securities. *See, e.g., Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990) (citing *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984)). However, as the district court noted, a participation in an instrument might in some circumstances be considered a security even where the instrument itself is not. *See Banco Espanol de Credito*, 763 F. Supp. at 41.

With respect to loan participations, the district court reasoned that "because the plaintiffs . . . did not receive an undivided interest in a pool of loans, but rather purchased participation in a specific, identifiable short-term

Integrated loan, the loan participation did not have an identity separate from the underlying loan." *Id.* at 42. Thus, because under *Chemical Bank* the loans to Integrated were not securities, the plaintiffs' purchase of discrete portions of these loans could not be considered securities.

On appeal, plaintiffs concede that traditional loan participations do not qualify as securities. Instead, plaintiffs contend that the peculiar nature of Security Pacific's loan participation program—which aimed at the sale of 100% of its loans through high speed telephonic sales and often pre-paid transactions—qualified these loan participations as securities. Specifically, plaintiffs argue that the loan participations sold by Security Pacific are more properly characterized as securities—in the nature of "notes"—as enumerated in § 2(1) of the 1933 Act.

In examining whether the loan participations could be considered "notes" which are also securities, the district court applied the "family resemblance" test set forth by the Supreme Court in *Reves*, 494 U.S. at 63-67. Under the family resemblance test, a note is presumed to be a security unless an examination of the note, based on four factors, reveals a strong resemblance between the note and one of a judicially-enumerated list of instruments that are not securities. *Id.* at 65. If the note in question is not sufficiently similar to one of these instruments, a court must then consider, using the same four factors, whether another category of non-security instruments should be added to the list. *Id.* at 67. The four *Reves* factors to be considered in this examination are: (1) the motivations that would prompt a reasonable buyer and seller to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) whether some factor, such as the exis-

tence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary. *Id.* at 66-67.

In addressing the first *Reves* factor, the district court found that Security Pacific was motivated by a desire to increase lines of credit to Integrated while diversifying Security Pacific's risk, that Integrated was motivated by a need for short-term credit at competitive rates to finance its current operations, and that the purchasers of the loan participations sought a short-term return on excess cash. Based on these findings, the district court concluded that "the overall motivation of the parties was the promotion of commercial purposes" rather than an investment in a business enterprise. *Banco Espanol de Credito*, 763 F. Supp. at 42-43.

Weighing the second *Reves* factor—the plan of distribution of the instrument—the district court observed that only institutional and corporate entities were solicited and that detailed individualized presentations were made by Security Pacific's sales personnel. The district court therefore concluded that the plan of distribution was "a limited solicitation to sophisticated financial or commercial institutions and not to the general public." *Id.* at 43.

With regard to the third factor—the reasonable perception of the instrument by the investing public—the district court considered the expectations of the sophisticated purchasers who signed MPA's and determined that these institutions were given ample notice that the instruments were participations in loans and not investments in a business enterprise. *Id.*

Finally, the district court noted that the Office of the Comptroller of the Currency has issued specific policy guidelines addressing the sale of loan participations.

Thus, the fourth factor—the existence of another regulatory scheme—indicated that application of the securities laws was unnecessary. *Id.*

Thus, under the *Reves* family resemblance analysis, as properly applied by the district court, we hold that the loan participations in the instant case are analogous to the enumerated category of loans issued by banks for commercial purposes and therefore do not satisfy the statutory definition of "notes" which are "securities." Since the loan participations do not meet the statutory definition of securities, plaintiffs may not maintain their action for relief under § 12(2) of the 1933 Act.

Turning to plaintiffs' contractual and other common-law claims, we agree with the district court that the waiver provision in the MPA's signed by the loan participants specifically absolved Security Pacific of any responsibility to disclose information relating to Integrated's financial condition. Moreover, as an arms length transaction between sophisticated financial institutions, the law imposed no independent duty on Security Pacific to disclose information that plaintiffs could have discovered through their own efforts. *See, e.g., Aaron Ferer & Sons v. Chase Manhattan Bank*, 731 F.2d 112, 122 (2d Cir. 1984).

CONCLUSION

Based on the foregoing, and on Judge Pollack's well-reasoned opinion, we affirm the judgment of the district court.

OAKES, *Chief Judge*, dissenting:

I believe that the majority opinion mistakenly assumes that the debt instruments—which Security Pacific terms "loan notes"—were sold in a "loan participation" and hence were not "securities." In doing so, I fear that the majority opinion misreads the facts, makes bad banking law and bad securities law, and stands on its head the law of this circuit and of the Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). Accordingly, I dissent.

For reasons that I will explain in detail, I agree with the Securities and Exchange Commission, which submitted a brief amicus curiae, a brief which is not mentioned in the majority opinion, that these so-called loan notes were purchased in investment transactions and are securities accordingly, and that the loan note program engaged in by Security Pacific, while bearing a superficial resemblance to traditional loan participations, differs from those traditional participations in several important respects, including (1) who the participants are; (2) what the purposes of the purchasers or participants are; and (3) what the promotional basis used in marketing the loan notes is. The participants, rather than being commercial lenders who engage in traditional loan participations, were instead in many cases non-financial entities not acting as commercial lenders but making an investment, and even though there were some banks that purchased the so-called loan notes, they generally did so not through their lending departments but through their investment and trading departments. These participants were motivated not by the commercial purpose of operating a lending business in which participations are taken as an adjunct to direct lending operations, but were motivated by an investment purpose. The promotional literature put out by Security Pacific advertised the so-called loan notes as

competitive with commercial paper, a well-recognized security under the Securities Act, and on the basis of the return that they offered over that of other investments.

Beyond that, and importantly to the Securities Act aspect of the case, these loan notes differ from traditional loan participations in the scope of information available to the purchasers. In the traditional loan participation, participants generally engage in one-to-one negotiation with the lead lender, and at times with the borrower, and can inspect all information, public and non-public, that is relevant, and consequently are able to do their own credit analysis. Here, Security Pacific did not provide the participants with non-public information it had, provided only publicly-available documents or ratings, and the purchasers were not in a position to approach the hundred or more possible borrowers in the program and conduct their own examinations. This is important for, as emphasized in *Reves*, 494 U.S. at 60, "[t]he fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market.' *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975)." It is for this reason—overlooked by the majority—that "because the Securities Acts define 'security' to include 'any note,' we begin with a presumption that every note is a security." *Reves*, 494 U.S. at 65.

I have said above that I believe the majority has misread the facts. Security Pacific is a California-based national banking association, a so-called money center bank, which through its division Security Pacific Merchant Bank ("Merchant Bank") has since 1985 conducted what it calls a "commercial loan note program." In that program, Security Pacific sells to a variety of financial and non-financial institutions and other entities its so-called loan notes. While these purchasers included foreign

and domestic banks, 53 percent of them were not financial institutions; 23 percent were corporations; 18 percent were institutional investors; 4 percent were insurance companies; 2 percent were mutual funds; 2 percent were trust departments; and 4 percent were money managers, all of the above typically purchasing loan notes in a minimum amount of one million dollars. These notes are unsecured, have short-term maturities ranging from overnight to one year, with a concentration in the overnight to 30-day range. The program was conducted by Merchant Bank's corporate debt department, situated in a room where several trading operations were conducted, including those involving government instruments, foreign currency, and Euro-dollar futures. That department was not part of the commercial loan operation of Security Pacific. The program was created to allow Security Pacific to compete with investment bankers who could place short-term commercial paper for corporations at a lower cost than traditional commercial bank loans, that commercial paper unquestionably being securities. Indeed, Security Pacific's promotional literature advertised loan notes as follows: "Commercial Loan Notes yield 15 to 50 basis points more than their commercial paper equivalents." The borrowers, to whom Security Pacific referred as "issuers," were first analyzed by the bank's credit officers, and once approved obtained an internal, uncommitted, unsecured credit line separate from the bank's traditional commercial loan limits. This line established how much in advances to that issuer Security Pacific could hold at any one time, but did not impose a limit on the amount of loan notes that the Merchant Bank corporate debt department could sell to others. In this case, for example, the issuer's credit line was 10 million dollars, but the participations sold to

others at the time of default amounted to more than 80 million dollars.

Entities expressing an interest in participating as purchasers, sometimes contacted by the bank through "cold calls," usually signed a Master Participation Agreement ("MPA") before their first purchase, governing all subsequent purchases. The notes were sold with recourse against the borrower only and no recourse against Security Pacific, whose duty was simply to collect payments on the underlying note payable to it and pay collections to the participants. The MPA purported to relieve Security Pacific of liability for "any error in judgment or for any action taken or omitted to be taken by it, except for gross negligence or willful misconduct." The MPA also relieved Security Pacific of any obligation as to any representation concerning the financial condition of a borrower or duty to inspect the books and records of a borrower or responsibility for the collectibility of any loan. In addition, the MPA required participants to acknowledge that they had "independently and without reliance upon" Security Pacific, made their own credit analysis and decision to purchase a participation.

According to Security Pacific's promotional literature,

> Security Pacific's strong trading capabilities afford *investors* a large selection of issuers, maturities, and amounts from which to choose. Our traders and sales professionals work closely with *investors* in order to match their individual *investment* needs.
> (Emphasis supplied.)

It also promoted the liquidity of the instrument, stating that Security Pacific would "make a bid on a Security Pacific-originated loan note on a best efforts basis and represented that although it did not 'fully commit to make

a secondary market in loan notes,' its 'trading and distribution capabilities should afford [purchasers] liquidity in most cases.' " From 1986 through October 1990, a total of 843 entities purchased one or more loan notes in the program, and as of 1989 Security Pacific had approximately six to seven hundred investors and approximately one hundred to two hundred fifty active borrowers. Nor was this a program limited to Security Pacific. As pointed out in the SEC amicus brief, the 1980s, in addition to seeing the era of "junk bonds," saw a vast expansion of sales by large money center banks of participations in short-term loans made to corporate buyers, sort of an evolution out of old-style banking into investment banking, in an effort to compete with the borrowing of money through debt instruments, such as commercial paper, rather than through traditional bank loans. The SEC estimates that the total market for these loan notes is considerable, with annual sales by all sellers estimated in excess of 100 billion dollars a year. This case, therefore, is not exactly about chicken feed.

We start off by looking at the broad definition of "security" within the meaning of section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2) (1988).[1] Section 2(1), 15 U.S.C. § 77b(1) (1988), defines "security" to mean "any note, . . . evidence of indebtedness, . . . or any certificate of interest or participation in . . . any of the foregoing."

The legal question we have before us is whether the notes issued by Integrated Resources, Inc. ("Integrated")

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1 Section 12(2) by its terms applies whether or not the security is exempt under section 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(3) (1988), which exempts notes and other paper, used for current operations, with maturity of not exceeding nine months.

were securities within the meaning of section 12(2) of the Securities Act of 1933.

We start with the proposition as set forth in Justice Marshall's opinion for the Court in *Reves* that Congress "recognized the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.' " 494 U.S. at 60-61 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946)) and with the proposition that "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." 494 U.S. at 61. The Court there adopted the Second Circuit's "family resemblance" test as set forth in, *e.g.*, *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976), 494 U.S. at 64-65, with certain modifications, however. The first such modification is that the Second Circuit test provided that only notes with a term of more than nine months were presumed to be securities. *Exchange Nat'l Bank of Chicago*, 544 F.2d at 1137-38. The Supreme Court in *Reves* refused to express any view on whether the '34 Act statutory exception for notes with a maturity of nine months or less affected the presumption that every note is a security. 494 U.S. at 65 n.3. The Court did agree, however, that types of notes that are not "securities" include

> the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in

> the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized),

494 U.S. at 65 (quoting *Exchange Nat'l Bank of Chicago*, 544 F.2d at 1138), and "notes evidencing loans by commercial banks for current operations," *id.* (quoting *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984)). But the Court added that "[m]ore guidance . . . is needed," especially since the Second Circuit list "is 'not graven in stone.' " *Id.* at 65-66 (quoting *Chemical Bank*, 726 F.2d at 939).

The additional guidance consisted in applying a four factor test. The first factor is the motivations that would prompt a reasonable seller and buyer to enter into the transaction. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is more likely to be a security, while if the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good or to correct for the seller's cash flow difficulties or advance some other commercial or consumer purpose, the note is less sensibly described as a "security." The second factor is the plan of distribution of the instrument. If it is an instrument in which there is "common trading for speculation or investment," *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943), then it is more likely to be a security. The third factor is the reasonable expectations of the investing public. Finally, the Court examines whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument. *Reves*, 494 U.S. at 66-67.

Judge Wright, in his concurring opinion in *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976), put the difference between lending banks (and hence real loan participants) and the investors here involved very well:

> While banks are subjected to risks of misinformation, their ability to verify representations and take supervisory and corrective actions places them in a significantly different posture than the investors sought to be protected through the securities acts.
>
> In an investment situation, the issuer has superior access to and control of information material to the investment decision. Rather than relying solely on semi-anonymous and secondhand market information, as do most investors, the commercial bank deals "face-to-face" with the promisor.

Id. at 1261-62 (Wright, *J.*, concurring). Judge Wright's "approach" in using this language was referred to by Judge Friendly in *Exchange Nat'l Bank of Chicago*, 544 F.2d at 1136, as "rather appealing," though his opinion for the court declined to accept Judge Wright's suggestion that no note given to evidence a bank loan can be a "security." *Id.* at 1137. In other words, Judge Friendly disapproved Judge Wright's approach as carrying too far the exemption from the securities acts for commercial bank loans negotiated face-to-face. In *Chemical Bank*, 726 F.2d at 938 & n.14, Judge Friendly noted the intervening approval (by way of a *cf.* cite) by the Supreme Court of the Wright *Great Western* concurrence in *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.10 (1982). Here, the originating bank, Security Pacific, had no commitment to transfer full credit information and eschewed any duty to the investors, providing only publicly-available infor-

mation and not an independent credit analysis. The fact that the purchasers here were sophisticated entities does not exclude them from being considered a "broad segment of the public," *Reves*, 494 U.S. at 68. And that is all the Court has held to be necessary to establish the requisite "common trading" in an instrument. *See, e.g., Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) (stock of closely-held corporation); *W.J. Howey Co.*, 328 U.S. at 295 (units of citrus grove and maintenance contract not traded on exchange).

Moreover, it is important to look at Security Pacific's overall loan note program and not just at the sale of Integrated notes. Potential purchasers were not presented with one loan and asked if they wanted to participate in it, but were solicited, often on a daily basis, and offered a range of investment options involving different issuers with different maturities and interest rates. The investors were looking for short-term means to place excess cash and were motivated by the maximum return available from the investments offered. The bottom line is that the market closely resembles the commercial paper market which Judge Lasker once described as involving "a series of brief telephone conversations" between buyer and seller, *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 885 (S.D.N.Y. 1976), and, as he pointed out, "because of the large amounts involved buyers understandably desire to complete the transaction on the date of the sale to avoid losing a day's interest," *id.*, which is the very case here. Whatever the language of the MPAs relied upon by the majority and the district court, the language of the promotional literature repeatedly referred to "investors" and "investments."

Thus, I consider the four-part test of *Reves* applied to the facts here to make the so-called loan notes "securities" under section 12(2), and would reverse.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 91-7563, 91-7571
Filed September 8, 1992

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 8th day of September, one thousand nine hundred and ninety-two.

BANCO ESPANOL DE CREDITO; BANESTO BANKING CORPORATION; BANCO TOTTA & ACORES; GIROZENTRALE UND BANK DER OSTERREICHISCHEN SPARKASSEN AG; HARMONY GOLD LTD. HONG KONG; INTERNATIONAL COMMERCIAL BANK OF CHINA; MONROE BANK & TRUST; PHELPS DODGE CORPORATION; SAUDI AMERICAN BANK; STATE STREET BANK & TRUST COMPANY, as Master Trustee for the Retirement Plans of Atlantic Richfield Company and certain of its subsidiaries,

Plaintiffs-Appellants,

—against—

SECURITY PACIFIC NATIONAL BANK;
SECURITY PACIFIC MERCHANT BANK,

Defendants-Appellees.

HACHIJUNI BANK, LTD.,

Plaintiff-Appellant,

—against—

SECURITY PACIFIC NATIONAL BANK;
SECURITY PACIFIC MERCHANT BANK,

Defendants-Appellees.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that *Banco Espanol v. Security Pacific*, Nos. 91-7563, -7571, slip op. 4959 (2d Cir. June 24, 1992) is amended as follows:

At slip op. 4963, line 4 after "rates." is inserted:

> Resales of these loans were prohibited without Security Pacific's express written consent.

At slip op. 4966, line 3 after "Thus," is inserted:

> Judge Pollack reasoned,

At slip op. 4967, at the end of the second full paragraph, after "*id.* at 43." is inserted:

> We agree.
>
> The plan of distribution specifically prohibited resales of the loan participations without the express written permission of Security Pacific. This limitation worked to prevent the loan participations from being sold to the general public, thus limiting eligible buyers to those with the capacity to acquire information about the debtor. This limitation also distinguishes *Gary Plastics Packaging v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), which involved a secondary market for the instruments traded in that case.

At slip op. 4968 at the end of the first full paragraph is inserted:

> We rule only with respect to the loan participations as marketed in this case. We recognize that even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities. *See Gary Plastic Packaging*, 756 F.2d 240-42.

/s/ Wilfred Feinberg
WILFRED FEINBERG by FXA

/s/ Frank X. Altimari
FRANK X. ALTIMARI

Judge Oakes dissents from this order.

OAKES, *Circuit Judge*, dissenting:

While I think that the changes in the panel majority opinion do a lot to narrow the scope and, hence, the impact of its decision, even with those changes I think the decision wrong, for reasons previously stated. I therefore continue to dissent.

UNITED STATES DISTRICT COURT
S.D. NEW YORK

Nos. 90 Civ. 2403 (MP), 90 Civ. 3315 (MP)

May 3, 1991

BANCO ESPANOL DE CREDITO, Banco Totta & Acores, Banesto Banking Corp., Girozentrale Und Bank Der Osterreichischen Sparkassen AG, Harmony Gold Ltd. Hong Kong, International Commercial Bank of China, Monroe Bank & Trust, Phelps Dodge Corporation, Saudi American Bank, and State Street Bank & Trust Company as Master Trustee for the Retirement Plans of Atlantic Richfield Company and Certain of its Subsidiaries,

Plaintiffs,

—v.—

SECURITY PACIFIC NATIONAL BANK and Security Pacific Merchant Bank,

Defendants.

THE HACHIJUNI BANK, LTD.,

Plaintiff,

—v.—

SECURITY PACIFIC NATIONAL BANK and Security Pacific Merchant Bank,

Defendants.

Howard, Darby & Levin by Jack P. Levin, Lawrence A. Darby, Vivien B. Shelanski, New York City, for plaintiffs Banco Espanol de Credito, Banco Totta & Acores, Banesto Banking Corp., Girozentrale Und Bank der Osterreichischen Sparkassen AG, Harmony Gold Ltd. Hong Kong, Intern. Commercial Bank of China, Monroe Bank & Trust, Phelps Dodge Corp., Saudi American Bank, State Street Bank & Trust Co. as Master Trustee for the Retirement Plans of Atlantic Richfield Co. and certain of its Subsidiaries, and Hachijuni Bank, Ltd.

Fried, Frank, Harris, Shriver & Jacobson by Jed S. Rakoff, Eric Queen, Marianna Koval, and Mudge, Rose, Guthrie, Alexander & Ferdon by Harold G. Levison, Michael C. Harwood, New York City, for defendants Sec. Pacific Nat. Bank and Sec. Pacific Merchant Bank.

DECISION AND OPINION

MILTON POLLACK, *Senior District Judge.*

The parties have cross-moved pursuant to Rule 56 Fed.R.Civ.P., for summary judgment herein in favor of the plaintiffs and defendants respectively. Defendant has also moved for judgment on the pleadings in pursuance of Rule 12(c).

The parties have filed a Joint Statement of Undisputed Material Facts. Those facts and the depositions which are part of the record for the motions, sufficiently provide the basis for a Rule 56 determination of the issues. Although the parties also submitted disputed versions of other matter, those submissions were not essential to a determination of the issues presented.

For the reasons indicated hereafter, summary judgment dismissing the complaints will be granted to the defendants.

I.

Each case must be decided on its own facts. This principle is especially applicable here. The expansive submissions covering banking practices in the industry and among other banks

provide interesting and controversial reading, but these cases are to be decided on the facts pertaining to the transactions between these parties.

The plaintiffs contend that they purchased from the defendant, a commercial bank, a "security" subject to the rescission benefits of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2), as amended, and federal jurisdiction herein is posited on this contention. The plaintiffs are eight commercial banking institutions, two corporations, and one substantial Pension Trust.

Count I of the complaint seeks a recovery under the federal law; Count II asserts a claim of breach of contract between the parties; Count III asserts a breach of an alleged implied covenant of good faith and fair dealing; Count IV charges tortious misrepresentations by the defendant; and Count V claims breach of an alleged duty to disclose based on superior knowledge.

The plaintiffs purchased from Security Pacific, the defendant bank, 100% or, in some cases, lesser participations in short-term bank loans[1] made by Security Pacific to one of its regular banking customers, Integrated Resources Inc. ("Integrated"), to whom it had been making loans for a number of years. Integrated was a financial service organization. The loans in question were made to facilitate the latter's current business operations in 1989. Integrated defaulted on its most recent loans, before maturity thereof and ultimately went bankrupt. Plaintiffs now sue Security Pacific (Count I) for the recovery of the unpaid loans, contending that the participations purchased were securities and that they were sold by Security Pacific to the plaintiffs with knowledge of negative financial information concerning Integrated that should have been called to the attention of plaintiffs. Fraud is not charged. The remaining Counts assert state law claims.

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1. On the argument of this motion, plaintiff attempted to claim that the Advances to Integrated were not "loans." However, the joint statement of undisputed facts labelled the Advances as "short-term advances/loans," and referred to the "loan notes/loan participations" and "short-term loan participations," in 29 different paragraphs of the joint statement, e.g. ¶ 1, 2, 3, *et al.*

Security Pacific denies the applicability herein of federal securities law and denies that the banking transactions involved a security within the statutory definition thereof and if they did, that the Act does not apply to any security issued or guaranteed by any bank. 15 U.S.C. § 77c(a)(2). The participation contract, a Master Participation Agreement ("MPA"), entered into by each plaintiff, places on each plaintiff alone the entire responsibility for due diligence in ascertainment and appraisal of Integrated's creditworthiness. Security Pacific contends that it owed plaintiffs none of the alleged legal duties set forth in the complaints.

There is no basis on which to question that the short-term multi-million dollar loans made by Security Pacific to Integrated were made to facilitate its current operations and that the sale of participations therein were covered by the MPA.

II. *Specific Provisions of the MPA*

The MPA spelled out the contractual agreements between the parties and described the business arrangement as involving the sale of a "loan." As set out therein, Security Pacific acted as manager of the loan. It made the advance to the borrower (Integrated) and where a purchase of the loan in whole or in part was agreed on, it debited a specific account of the plaintiff at Security Pacific in the amount of the purchased participation. It collected the loan when due from Integrated and allocated the agreed proceeds to the respective purchaser-participant.

The MPA provided: *inter alia*:

> 1. . . . For purposes of this Agreement, an "Asset" shall be:
>
> (a) *a loan* evidenced by a promissory note payable to the order of Security (or otherwise evidenced and payable to Security) denominated in U.S. dollars or foreign currency, or
>
> (b) a Participation in a promissory note (or other evidence of obligation) payable in U.S. dollars or foreign currency to a lender (a "Lender") and purchased by Security under a participation agreement. . . .

The relationship between Security and the Participant is and shall be that of a seller and purchaser of a property interest and not that of a debtor and creditor.

. . . .

4. Security shall exercise the same care in the administration and enforcement of any Asset as if it had retained the entire Asset for its own account, but it shall not be liable for any error in judgment or for any action taken or omitted to be taken by it, except for gross negligence or willful misconduct. Without limitation of the generality of the foregoing, Security . . . (b) makes no warranty or representation . . . and shall not be responsible for any statement, warranty or representation made in connection with any Asset or any document relative thereto or for the financial condition of any Borrower, Lender or Guarantor or for the value of any Collateral, (c) shall not be responsible for the performance or observance of any of the terms, covenants or conditions of any Asset or any document relative thereto and shall not have any duty to inspect the property (including the books and records) of any Borrower, Lender or Guarantor, (d) makes no warranty or representation as to and shall not be responsible for the due execution, legality, validity, enforceability, genuineness, sufficiency or collectibility of . . . any Asset or any document relative thereto or any Collateral held as security for any Asset. . . .

. . . .

5. The Participant acknowledges that it has, independently and without reliance upon Security and based upon such documents and information as the Participant has deemed appropriate, made its own credit analysis and decision to purchase each Participation hereunder. . . .

. . . .

11. The Participant's participation in each Asset shall be on a silent basis and shall not be subdivided or transferred without the prior written consent of Security.

There is no question that the plaintiffs each agreed to make their own credit analysis of Integrated and do whatever was

needed to keep themselves informed of Integrated's financial condition without any reliance on or assistance from Security Pacific. The MPA provided that Security Pacific was under no duty to inspect Integrated's books and records, nor to make a financial analysis of Integrated. Indeed, should Security Pacific do a financial analysis of it banking customers, it was under no duty to disclose the results to plaintiffs. The MPA exonerated any negligence of the defendant for failing to act on any financial analysis information coming to its attention that might be deemed to affect Integrated's creditworthiness.

Thus, the originating bank adopted no responsibilities for the integrity or payment of the loans—no obligation to the borrower (Integrated)—no obligation to the purchaser therefor. The purchase was fully without recourse excepting only to turn over to the purchaser collections obtained thereon.

III. *Background*

Integrated Resources Inc. was a regular banking customer of defendant Security Pacific. From time to time the defendant made loans to Integrated on an overnight or short-term maturity basis (less than six months) to finance the latter's short-term cash needs, each loan having a particular maturity date and bearing interest at a particular rate. Security Pacific's advances were evidenced by a promissory note. From time to time, as Security Pacific made advances to Integrated, it offered participation therein to various of the plaintiffs to the maturity of the underlying loan, with interest and principal payable at maturity. The short-term loan involved offered yields superior to comparable money market instruments for placement of the participant's excess cash at interest, such as in Federal Funds, Commercial Paper, Certificates of Deposit or Eurodollar Deposits. The selection of the loan in which to participate was made by the respective plaintiff based on that plaintiff's own liquidity requirements. The participation was without recourse to Security Pacific. The minimum amount of the participation offered by Security Pacific was generally a million dollars, and the 17 participations by the 11 plaintiffs at

issue herein, varied in amounts from one million dollars to ten million dollars with one participation at $600,000.

Security Pacific was the manager of each loan to Integrated and the allotted participation therein. Security Pacific was compensated for its management services by the difference between the interest rate it received from Integrated and the lower rate payable to the loan participant thereon.

Creditworthiness of Integrated was the initial basis of the relationship between it and Security Pacific. This was implemented with a line of credit under which each loan was made. Omnibus arrangements were made with Integrated for revolving loans and their repayment and there were known objects for the ongoing financing.

Typically, Integrated or any similar banking customer, entered into the a short-term loan program as a borrower after a credit check performed by Security Pacific's credit group. A credit limit for the borrower was set and the borrower would sign and deliver to Security Pacific the so-called Multiple Advance Note.[2] Upon agreement to a requested loan, Security Pacific made the loan and confirmed it. Borrowers were normally reviewed once a year by the credit department of Security Pacific and could be removed by this group from the program for unacceptable credit risks.

Prospective purchasers of the participations from Security Pacific were not subject to an approval process. However, Security Pacific's salespersons would identify whether an entity had sufficient capital to participate. Individuals were excluded.

Security Pacific provided the plaintiffs with an advance list of the bank's customer/borrowers, including Integrated, and with the Standard & Poors rating of the customer/borrower's commercial paper. Integrated was rated A2 at the times here involved. This pre-screening list gave each prospective loan purchaser the opportunity to do its own due diligence check on the creditworthiness of Security Pacific's customer and then,

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2 Integrated signed such a note to cover all advances from Security Pacific. *See*, Hundley, Exh. 8, and reference thereon to "grid note"; *see also*, Molloy Depos. at 117-18; Ahn Depos. at 143.

on the prospective purchaser's own appraisal, to select borrowers and their loans that the former would be interested in.

Upon verbal agreement on the loan selected, the terms of a sale, and the extent of participation desired, a confirmation was sent to the respective participant reciting among other things that it was subject to the MPA. Public information pertaining to Integrated was available from Security Pacific, upon request. Non-public information was not usually shared between Security Pacific and those who purchased a participation.

Under express terms of the MPA, purchasers of the whole of a loan or of a participation in a loan made to Integrated had no right to trade it without the prior written permission of Security Pacific—which was not requested nor given.

All of the individual loans to Integrated in which some one of the plaintiffs participated and which were defaulted, were allotted to a plaintiff in the period from April 10, 1989 and June 9, 1980; the respective loans matured variously up to November 8, 1989. Each plaintiff purchased and received a specific dollar interest in an identifiable loan—not an undivided interest in a loan portfolio.

IV. *Applicable Legal and Regulatory Principles*

Section 2(1) of the 1933 Act provides: "[U]nless the context otherwise requires—(1) the term 'security' means any note . . . evidence of indebtedness, . . . investment contract, . . . or any certificate of interest or participation in . . . any of the foregoing." 15 U.S.C. § 77b(1).

Section 3(a)(2) and (3) of the 1933 Act provides: "Except as hereinafter expressly provided, the provisions of this title *shall not apply to* any of the following classes of securities: . . . (2) . . . *any security issued or guaranteed by any bank* . . . (3) [a]ny note . . . which has a maturity at the time of issuance of not exceeding nine months". 15 U.S.C. § 77c(a)(2) & (3) (emphases supplied).

Section 12(2) of the 1933 Act provides: "Any person who— . . . (2) offers or sells a security (*whether or not exempted by the provision of section 3, other than by the paragraph (2) of*

subsection (a) thereof), . . . shall be liable". 15 U.S.C. §77l(2) (emphases supplied).

The language in the 1933 and 1934 Acts in the definitions of the term "security" is not exactly identical; however, the Supreme Court has stated that the definitions of "security" will be treated as identical "in our decisions dealing with the scope of the term." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n. 1, 105 S.Ct. 2297, 2301 n. 1, 85 L.Ed.2d 692 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 555 n. 3, 102 S.Ct. 1220, 1223 n. 3, 71 L.Ed.2d 409 (1982); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 847 n. 12, 95 S.Ct. 2051, 2058 n. 12, 44 L.Ed.2d 621 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 335-36, 88 S.Ct. 548, 552-53, 19 L.Ed.2d 564 (1967).[3]

In defining a "security" the '33 Act makes clear through its introductory phrase that the definition thereof given in the statute is the guide "unless the context otherwise requires." 15 U.S.C. § 77b(1). Thus, literalism is negated, for "in searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherpnin*, 389 U.S. at 336, 88 S.Ct. at 553, *quoted* in *United Housing Foundation*, 421 U.S. at 848, 95 S.Ct. at 2058. *See also, SEC v. W.J. Howey Co.*, 328 U.S. 293, 298, 66 S.Ct. 1100, 1102, 90 L.Ed. 1244 (1946). Unusual instruments "not easily characterized as 'securities,' " such as those litigated here, will require looking to "the economic substance of the transaction, rather than just to its form, to determine whether the Act applied." *Landreth Timber*, 471 U.S. at 688, 690, 105 S.Ct. at 2302, 2204, *cited* in 2 L. Loss & J. Seligman, *Securities Regulation* 872-73 (3d ed. 1989).

It is settled law that certificates evidencing loans by commercial banks to its customers for their current operations are not securities. *Reves v. Ernst & Young*, 494 U.S. 56, 110 S.Ct. 945, 951, 108 L.Ed.2d 47 (1990) (approving holding and fam-

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3 The Senate Report on the Securities Exchange Act similarly observed the definition of security in that Act is "substantially the same" as the definition in the Securities Act. S.Rep. No. 792, 73d Cong., 2d Sess. 14 (1934). See also H.R. Rep. No. 1383, 73d Cong., 2d Sess. 17 (1934).

ily resemblance test of *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.), *cert. denied*, 469 U.S. 884, 105 S.Ct. 253, 83 L.Ed.2d 190 (1984)); *American Bank & Trust Co. v. Wallace*, 702 F.2d 93, 97 (6th Cir.1983); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1260 (9th Cir.1976); *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1362 (7th Cir.), *cert. denied*, 423 U.S. 825, 96 S.Ct. 38, 46 L.Ed.2d 40 (1975); *Bellah v. First National Bank*, 495 F.2d 1109, 1114 (5th Cir.1974).

Although the underlying instrument is not a security, a participation in a non-security could itself be a security. *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F.Supp. 1263, 1267 (S.D.N.Y.1978) ("It is quite logical, and is moreover well established, that a participation in a loan may be a security, even though the underlying loan is not." (citing cases)); *see also NBI Mortgage Investment Corp. v. Chemical Bank* [1976 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 95,632 at 90,146 (S.D.N.Y.1976).

The recent cases hold that participations in commercial loans are not "securities." 2 L. Loss & J. Seligman, *supra*, at 891 n. 66 ("In reaching this conclusion most recent cases concluded that a loan participation is not an investment contract under the *Howey* test."). Every circuit court that has ever considered the question has concluded that loan participations are not securities. *McVay v. Western Plains Service Corp.*, 823 F.2d 1395, 1398-1400 (10th Cir.1987); *Union National Bank of Little Rock v. Farmers Bank*, 786 F.2d 881, 884-85 (8th Cir.1986); *Kansas State Bank in Holton v. Citizens Bank of Windsor*, 737 F.2d 1490, 1493-95 (8th Cir.1984); *Union Planters National Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1180-85 (6th Cir.), *cert. denied*, 454 U.S. 1124, 102 S.Ct. 972, 71 L.Ed.2d 111 (1981); *American Fletcher Mortgage Co. v. U.S. Steel Credit Corp.*, 635 F.2d 1247, 1253-55 (7th Cir.1980), *cert. denied*, 451 U.S. 911, 101 S.Ct. 1982, 68 L.Ed.2d 300 (1981); *United American Bank of Nashville v. Gunter*, 620 F.2d 1108, 1115-19 (5th Cir.1980).

Although the Second Circuit has not had occasion to rule on the question of whether a loan participation is a security, Dis-

trict Judge Kevin T. Duffy (himself a former SEC regional administrator) held in *Vorrius v. Harvey*, 570 F.Supp. 537 (S.D.N.Y. 1983), that "loan participations" were not securities where, as in the instant case, there exists protection under the federal banking laws, the purchase of the loan participation is a result of one-to-one negotiation between the plaintiff and defendant, and the purchaser is personally in a position to watch and protect its investment. Id. at 540. *But see Commercial Discount Corp.*, 445 F.Supp. at 1267-68.

This court recently stated in an analogous context in *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F.Supp. 531, 553 (S.D.N.Y.1990) (Pollack, J.):

> A participation in a banker's acceptance gives the purchasers an interest in that banker's acceptance. It does not give the purchaser an undivided interest in a pool of banker's acceptances. It is only a partial interest in an exempt underlying security and shares all of the underlying banker's acceptance's attributes. . . . Because a participation in a banker's acceptance does not have an identity separate from the banker's acceptance, the participation is not a "security."

Id. Similarly, because the plaintiffs here did not receive an undivided interest in a pool of loans, but rather purchased participation in a specific, identifiable short-term Integrated loan, the loan participation did not have an identity separate from the underlying loan. Since the underlying loan is not a security, neither is the participation therein.

Even the plaintiffs do not contest that "traditional" loan participations are not securities. What they are arguing is that the participations at issue arising in a short-term loan program are wholly different from traditional loans by the bank. Specifically, to refute the conclusion that would follow from the application of the *Mishkin* analogy, the plaintiffs contend that there is no independent underlying instrument that warrants the application of the *Mishkin* analysis. They are almost asserting that the underlying loans to Integrated are sham. They stress the fact that (1) the sale of a 100% participation was the object

intended by Security Pacific, (2) participants were not limited to banks, (3) the role of Security Pacific was to match participants and borrowers, and (4) loan participations bear strong resemblance to commercial paper which is a security.

The basic claim by plaintiffs appears to be that the Security Pacific's loan participations ar a new type of instrument, different from traditional loan participations, and therefore are "notes" or "investment contracts" under § 2(1) of the '33 Act. However, the participations at bar are not "notes" and not "investment contracts."

In *Reves v. Ernst & Young*, 494 U.S. 56, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990), the Supreme Court stated that in determining whether an instrument denominated a "note" is a "security," courts are to start out by presuming that a note is a security, but that presumption may be rebutted by a showing that the note bears a strong resemblance to one of the enumerated categories which the Supreme Court set forth in *Reves*, *id.*, 110 S.Ct. at 951, of non-securities, to be tested by four factors: 1) the motivations that would prompt a reasonable seller and buyer to enter into it; 2) the plan of distribution of the instrument; 3) the reasonable expectation of the investing public; 4) existence of some other factor such as another regulatory scheme thereby rendering securities regulations unnecessary. *Id.* at 951-52. "If an instrument is not sufficiently similar to an item on the [non-security] list, the decision whether another category should be added [to that list] is to be made by examining the same factors." *Id.* at 952.

Applying these tests to the short-term loan participations sold by Security Pacific leads to the conclusion that these instruments bear a strong family resemblance to "loans by commercial banks [to customers] for current operations," *id.* at 951, which are a member of the non-security family.

The first factor to be considered and weighed is the motivation of the parties in entering this transaction. The uncontradicted motivation of the seller, Security Pacific, was to increase lines of credit available to Integrated as part of a continuing credit relationship. The sale of an Integrated loan would permit Security Pacific to diversify its risk among participants.

Security Pacific was recompensed by retaining the difference between the interest rate it had charged to Integrated and the lower rate payable to the participant on the sale of the loan. Self-evidently, Integrated's motivation was to have access to a source of short-term funds that was competitive with alternative short-term money market instruments to finance current operations or to cover a temporary cash shortage. The motivation of the participant in buying all or part of the loan was to use its excess cash by purchasing a short-term vehicle that would earn a fixed rate of interest that was higher than alternative money market instruments. Thus, the overall motivation of the parties was the promotion of commercial purposes and not investments in a business enterprise.

The second *Reves* factor is the plan of distribution of the instrument. The opportunity to purchase short-term participations was offered only to institutional and corporate entities with sufficient capital to engage in this program. Individuals were specifically excluded. The minimum purchase amount was generally $1 million. Potential participants were introduced to this program through oral presentations at industry seminars or individualized solicitation. Detailed explanations of the program were presented to the institutions in an individualized manner by Security Pacific sales personnel.

The actual loan participation certificates were issued pursuant to the terms of the MPA. The MPA was the contractual agreement between, and signed by, each participant and Security Pacific. Each consummated participation was memorialized in a written one-page confirmation that was telecopied to the participant. Loan participations were not freely negotiable, but were transferable only with the prior written consent of Security Pacific.[4]

The plan of distribution was thus a limited solicitation to sophisticated financial or commercial institutions and not to the general public.

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4 The absence of a secondary market for these instruments is not significant since secondary markets do not exist for certain known securities, such as commercial paper.

The third criterion is the reasonable perception of the instrument by the investing public. Since the Supreme Court has not defined "investing public" in the context of this *Reves* factor, it is unclear whether a subset of the general public could satisfy the definition. As previously noted, the general public was excluded from purchasing these instruments and were not targeted with promotional information. There is no indication that the general public was even aware of the existence of this program.

If "investing public" includes only institutions that would be targeted by Security Pacific sales personnel for inclusion on this program, the instruments could reasonably be viewed only as loan participations. The potential participant must read, negotiate and sign an MPA for inclusion in the program. A form of the MPA was included with the informational brochure. A reasonable sophisticated financial or commercial institution was on notice through the contractual provision that the instruments are participations in loans and not investments in business enterprises.

The fourth criterion is the existence of another regulatory scheme that makes application of the federal securities laws unnecessary. The Office of the Comptroller of the Currency has issued specific policy guidelines, Circular 181, addressing the purchase and sale of loan participation by national banks.[5] Since Security Pacific is a national bank, it is subject to this regulatory scheme.

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5 In 1984, the Comptroller of the Currency issued Banking Circular 181:

> A [loan] participation, as distinguished from a multibank loan transaction (syndicated loan), is an arrangement in which a bank makes a loan to a borrower and then sells *all or a portion* of that loan to a purchasing bank. All documentation of the loan is drafted in the name of the selling bank. Generally, the purchasing bank's share of the participated loan is evidenced by a certificate which assigns an interest in the loan and any related collateral. (Emphasis supplied.)

Banking Circular 181 (Rev.) [1984-1985 Transfer Binder] Fed. Banking L.Rep. (CCH) ¶ 60,799 at 38,858 (Aug. 2, 1984) (footnotes omitted).

A *Reves* analysis thus indicates that short-term loan participations sold by Security Pacific resemble loans issued by a bank for commercial purposes and accordingly are non-securities.

A sole possible remaining question is whether the participations in this case could be classed as "investment contracts." In *SEC v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946), the Supreme Court held that the test of whether an instrument is an "investment contract" under the securities law is whether it is an investment in a common venture with a reasonable expectation of profits to be derived from the entrepreneurial efforts of others. *Id.* 66 S.Ct. at 293-300.

As noted above, all federal circuit courts that have applied the *Howey* standard to the question whether a loan participation is an investment contract under federal securities laws have uniformly held that it is not. Considering and weighing the *Howey* criteria in the instant case reveals the following:

First, with respect to the element of "investment," considering the absence of a public offering and the very short-term nature of the loans and the participations therein, it is fair to associate the participations with the ordinary commercial risks taken by everyday lenders and not the longer-term, more fundamental risk characteristic of the true investment.

Second, as to the element of "reasonable expectation of profits," the Supreme Court has defined "profits" under the *Howey* test as meaning "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds." *United Housing Foundation*, 421 U.S. at 852, 95 S.Ct. at 2060. *Accord Reves*, 110 S.Ct. at 952 n. 4. In the present case, the plaintiffs had no expectation of capital appreciation from the monies placed in the loans; the rate of return consisted solely of the repayment of the principal plus a fixed rate of interest. MPA ¶ 2. The "receipt of interest is not directly tied to profitability in such a way as to make loan participations securities." *McVay*, 823 F.2d at 1399 (citation omitted).

Third, as to the requirement of "entrepreneurial efforts of others," since the principal and interest owed to the plaintiffs

were fixed, the return did not fluctuate depending upon the efforts of Integrated or Security Pacific.

The participations here fail the *Howey* tests.

V. *No Duty Was Breached*

Each plaintiff-purchaser accepted, without comment, a confirmation certificate that expressly state the sales were made pursuant to the MPA:

> We [Security Pacific] confirm our offer to sell to you under the Master Participation Agreement dated as of ____ between you and Security Pacific National Bank the following asset[.]

The plaintiffs seek to invoke a covenant of good faith and fair dealing in the relationship. However, courts do not impose an obligation which would be inconsistent with other terms of the contractual relationship and for which the parties did not bargain.

> [T]he implied covenant of good faith and fair dealing does not provide a court *carte blanche* to rewrite the parties' agreement. Thus, a court cannot imply a covenant inconsistent with terms expressly set forth in the contract. . . . Nor can a court imply a covenant to supply additional terms for which the parties did not bargain.

Hartford Fire Insurance Co. v. Federated Department Stores, Inc., 723 F.Supp. 976, 991 (S.D.N.Y.1989) (citations omitted).

The implied covenant of good faith does not "operate to create new contractual rights." *See Don King Productions, Inc. v. Douglas*, 742 F.Supp. 741, 767 (S.D.N.Y.1990).

The signed MPA directly contradicts any claim that Security Pacific was on notice that plaintiffs were relying on volunteering matters coming to its attention that arguably might seem negative in respect to Integrated's creditworthiness.

In the case of arm's-length transactions between large financial institutions, no independently imposed duty of volunteering disclosure exists. In *First Citizens Federal Savings &*

Loan Ass'n v. Worthen Bank & Trust Co., 919 F.2d 510 (9th Cir.1990), a participant sued the lead bank on the notion of an alleged breach of fiduciary duty, *inter alia*, after the borrower defaulted and participants incurred losses. In holding that there was no fiduciary duty or breach thereof, the Ninth Circuit stated that:

> Unlike the automatic, status-based fiduciary duty which exists, for example, between attorney and client, fiduciary duties among loan participants depend upon the terms of their contract. . . .
>
> . . . .
>
> In the context of loan participation agreements among sophisticated lending institutions, we are of the opinion that fiduciary relationship should not be inferred absent unequivocal contractual language. . . . Banks and savings institutions engaged in commercial transactions normally deal with one another at arm's length and not as fiduciaries. *See Aaron Ferer & Sons v. Chase Manhattan Bank*, 731 F.2d 112, 122 (2d Cir. 1984). This rule holds true for institutions engaged in loan participation agreements.

Id. at 513-14 (citations omitted).

In the above cited case, *Aaron Ferer & Sons v. Chase Manhattan Bank*, 731 F.2d 112, 122 (2d Cir.1984) (Pratt, J.), the Second Circuit states that "[a] correspondent bank relationship, standing along, does not create a [fiduciary] relationship." It also stated that:

> During the course of negotiations surrounding a business transaction, a duty to disclose may arise in two situations: first, where the parties enjoy a fiduciary relationship; the second, where one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge.

Id. at 123 (citations omitted).

In the case of arm's length transactions between large financial institutions, no fiduciary relationship exists unless one was created in the agreement. No confidential information is claimed to be involved herein and access to the supposed negative information was public and available by due diligence on the part of plaintiffs. Causation between the non-disclosure and injury would still be required and that this thoroughly negated by the agreement of the parties that the participants would not rely on Security Pacific but would conduct their own research.

When a contract is unambiguous, as is the MPA, the meaning of the contract is properly determined on a motion for summary judgement. Courts do not look beyond the expressed provisions of a contract to determine the contract's meaning. Rather, courts must enforce the legal relations in accordance with the meaning ascribed by the contract.

"[W]here the parties to an agreement have expressly allocated risks, the judiciary shall not intrude into their contractual relationship." *Grumman Allied Industries, Inc. v. Rohr Industries, Inc.*, 748 F.2d 729, 735 (2d Cir.1984). Judge Kaufman, writing for the Court, found contract language "unambiguous", and stated that, "[b]y giving effect to explicit contractual terms, a court has a better chance to carry out the intentions of the parties. Particularly where the two sides are sophisticated, their allocation of risk and potential benefit is properly treated as supreme to any conflicting understanding we may have." *Id.* at 734.

The express disclaimer provisions of the MPA preclude the common law claims asserted by the various plaintiffs.

CONCLUSION

Loan participations generated by a commercial bank initially for the benefit of the bank's regular customer, if litigable on the notion that participations therein are "securities" not commercial loans, portend grave practical consequences. A holding to that effect would then pose duties and penalties under the federal laws.

Registration requirements under federal laws would all but put an end to the flexibility of every day commercial loans conceived and intended for working capital purposes of a business if they were saddled with SEC requirements by labelling a loan participation therein as a security.

The Supreme Court has ruled that application of the securities law must be read with the economic realities underlying the transaction. *United Housing Foundation v. Forman*, 421 U.S. 837, 848, 95 S.Ct. 2051, 2058, 44 L.Ed.2d 621 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298, 66 S.Ct. 1100, 1102, 90 L.Ed. 1244 (1946).

Construction of the '33 Act and relief of the sort claimed here—if it were desirable—must be initiated by and derive from Congress or regulatory authorities. An industry-wide traditional understanding which negates the application of federal securities laws to commercial participations in short-term bank loans should not be overridden by this Court's technical acceptance of a literal definition of a statute whose purposes were not so intended and were enacted in a different context. The banking industry at large seemingly has universally acted upon the assumption that federal securities law is not applicable to such transactions and this case gives no indication that it should be otherwise.

The plaintiff-participants had the choice of finding their own customers and making direct loans on their own due diligence. They chose rather to assume the risks and to act on their own responsibility by purchasing without recourse to Security Pacific. The holder of the participation became the lender in fact with Security Pacific as its collection agent. That was their contractual bargain and expectancy. No claim is made of any fraud by Security Pacific. The participating purchasers did not purchase a security and there is no evidence that they intended to do so. The transactions at bar were primarily mercantile or consumer, rather than investment transactions, and did not involve a public distribution. *Cf.* American Law Institute proposed Fed. Secs. Code § 202(150(B)(iii) (1978).

These were private commercial loan contracts. There is no claim of misrepresentation of material facts—there were no duties such as claimed that were created or extant between the parties nor was their a breach of any duty owing to plaintiffs or of the MPA.

Summary judgment is granted to defendants. There are no genuine issues of material fact in dispute and defendants are entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c).

Complaints dismissed, with costs.

SO ORDERED.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 91-7563, 91-7571
Filed August 27, 1992

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-seventh day of August, one thousand nine hundred and ninety-two.

BANCO ESPANOL DE CREDITO; BANESTO BANKING CORPORATION; BANCO TOTTA & ACORES; GIROZENTRALE UND BANK DER OSTERREICHISCHEN SPARKASSEN AG; HARMONY GOLD LTD. HONG KONG; INTERNATIONAL COMMERCIAL BANK OF CHINA; MONROE BANK & TRUST; PHELPS DODGE CORPORATION; SAUDI AMERICAN BANK; STATE STREET BANK & TRUST COMPANY, as Master Trustee for the Retirement Plans of Atlantic Richfield Company and certain of its subsidiaries; HACHIJUNI BANK, LTD.,

Plaintiffs-Appellants,

—against—

SECURITY PACIFIC NATIONAL BANK;
SECURITY PACIFIC MERCHANT BANK,

Defendants-Appellees.

HACHIJUNI BANK, LTD.,

Plaintiff-Appellant,

—against—

SECURITY PACIFIC NATIONAL BANK;
SECURITY PACIFIC MERCHANT BANK,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by plaintiffs-appellants Banco Espanol de Credito, Banesto Banking Corporation, Banco Totta & Acores, et al., and Hachijuni Bank, Ltd., and a statement of the Securities and Exchange Commission, amicus curiae, having been filed in support of appellants' petition for rehearing and suggestion for rehearing in banc.

Upon consideration by the panel that decided the appeal, it is

Ordered that said petition for rehearing is DENIED. Judge Oakes dissenting.

It is further noted that a poll of the judges in regular active service having been taken on the suggestion for rehearing in banc and there being no majority in favor thereof, rehearing in banc is DENIED.

/s/ Elaine B. Goldsmith
ELAINE B. GOLDSMITH,
Clerk

by: Carolyn Clark Campbell
Chief Deputy Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Nos. 90 Civ. 2403 (MP), 90 Civ. 3315 (MP)

May 8, 1991

BANCO ESPANOL DE CREDITO, BANCO TOTTA & ACORES, BANESTO BANKING CORP., GIROZENTRALE UND BANK DER OSTERREICHISCHEN SPARKASSEN AG, HARMONY GOLD LTD. HONG KONG, INTERNATIONAL COMMERCIAL BANK OF CHINA, MONROE BANK & TRUST, PHELPS DODGE CORPORATION, SAUDI AMERICAN BANK, AND STATE STREET BANK & TRUST COMPANY AS MASTER TRUSTEE FOR THE RETIREMENT PLANS OF ATLANTIC RICHFIELD COMPANY AND CERTAIN OF ITS SUBSIDIARIES,

Plaintiffs,

—against—

SECURITY PACIFIC NATIONAL BANK and
SECURITY PACIFIC MERCHANT BANK,

Defendants.

THE HACHIJUNI BANK, LTD.,

Plaintiff,

—against—

SECURITY PACIFIC NATIONAL BANK and
SECURITY PACIFIC MERCHANT BANK,

Defendants.

The parties having cross-moved pursuant to Rule 56 F.R. Civ.P., for summary judgment, defendant having also moved for judgment on the pleadings pursuant to Rule 12(c), and the said motions having come before the Honorable MILTON POLLACK, Senior United States District Judge, and the Court thereafter on May 3, 1991, having rendered its decision and opinion (#67931), granting summary judgment to defendants, there are no genuine issues of material fact in dispute and defendants are entitled to judgment as a matter of law, F.R.Civ.P. 56(c), and dismissing the complaints with costs, it is,

ORDERED, ADJUDGED AND DECREED: That summary judgment be and is hereby granted to defendants as there are no genuine issues of material fact in dispute and defendants are entitled to judgment as a matter of law, F.R.Civ.P. 56(c), and it is further,

ORDERED, that the complaints be and they are hereby dismissed, with costs.

JOSEPH F. CLORT
Acting Clerk

Dated: NEW YORK, NEW YORK
May 8, 1991

Loan Participations by National Banks
OCC Policy Guidelines

Comptroller of the Currency. Administrator of National Banks NR 83-87. December 19, 1983. Banking Circular 181 (Rev.) August 2, 1984. Release and circulate in full text.

[OCC Release]

The Office of the Comptroller of the Currency (OCC) today [12-19-83] announced policy guidelines on loan participations by national banks. A participation occurs when a bank makes a loan and then sells it entirely or in part to another bank.

"We have always expected national banks to apply the same standards of credit review to these transactions as the bank applies to all its loans," said Senior Deputy Comptroller H. Joe Selby. "The purpose of today's announcement is to outline our policy in detail so it will be clear how we treat these arrangements. Loan participations can serve legitimate business needs, but safe and sound banking practice requires proper controls be applied."

The guidelines outlined by the OCC require satisfactory controls over the risk associated with loan purchases or participations. Such controls include:

—Written policies and procedures for the transactions;

—Disclosure by the selling bank of complete and regularly updated credit information on the obligor during the term of the loan; and

—Written documentation of all parties' rights and obligations in any arrangement to buy back loans or participations.

The OCC policy provides that a national bank abide by its own formal lending policy in these transactions. The purchasing bank must perform a complete analysis of the credit quality of the obligations to be purchased, document the obligations, thoroughly analyze collateral, and maintain complete and current credit information on the borrower throughout the term of the loan.

The selling bank must provide complete and current credit information to the purchasing bank on the loan's accrual status, the status of principal and interest payments, collateral values, lien status and any information on the borrower's continuing credit worthiness.

The OCC stipulated that any agreements to repurchase participated loans be reflected on the books of both the buying and the selling banks. The OCC also said that any loans subject to repurchase agreements are subject to the lending limit for national banks.

Today's announcement advised national banks that the sale or purchase of a low quality loan may be considered an unsafe and unsound banking practice by the OCC. Low quality loans include ones that are classified, non-accruing, in default on payments and those renegotiated or compromised because of the deteriorating financial condition of the obligor.

[*Banking Circular*]

Subject: Purchase of Loans in Whole or Part—
Participations

To: Chief Executive Officers of all National Banks, Senior Officers of all Federal Branches and Agencies, Deputy Comptrollers, District Administrators and all Examining Personnel

Summary

The purchase of loans and participations in loans may constitute an unsafe or unsound banking practice in the absence of satisfactory documentation, credit analysis, and other controls over risk.

Revision of Circular

The present Circular supersedes Banking Circular 181, issued on December 8, 1983

Scope

This Circular describes prudent purchases of loans and loan participations. A participation, as distinguished from a multi-

bank loan transaction (syndicated loan),[1] is an arrangement in which a bank makes a loan to a borrower and then sells all or a portion of that loan to a purchasing bank.[2] All documentation of the loan is drafted in the name of the selling bank. Generally, the purchasing bank's share of the participated loan is evidenced by a certificate which assigns an interest in the loan and any related collateral.

Background

The purchase and sale of loans and participations in loans are established banking practices. These transactions serve legitimate needs of the buying and selling banks and the public interest. However, recent abuses have highlighted the need for the Office to remind banks of prudent banking practices for these transactions.

Policy

The absence of satisfactory controls over risk may constitute an unsafe or unsound banking practice and thus cause for the OCC to seek appropriate corrective action through its administrative remedies. Satisfactory controls over the purchase of loans and participations in loans ordinarily include, but are not limited to, the following:

—written lending policies and procedures governing these transactions;

—an independent analysis of credit quality by the purchasing bank;

—agreement by the obligor to make full credit information available to the selling bank;

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1 This Circular was drafted to address safety and soundness concerns arising from the purchase of loans and participations in loans. Nevertheless, the practices outlined in the Circular are illustrative of those principles of prudent banking which generally apply to any multibank lending transaction. For example, a prudent member of a loan syndication would obtain full and timely credit information to conduct an informed and independent analysis of the credit in a manner consistent with its formal lending policies and procedures.

2 For the purposes of the Circular, a "loan" includes any binding agreement to advance funds on the basis of an obligation to repay the funds.

—agreement by the selling bank to provide available information on the obligor to the purchaser; and

—written documentation of recourse arrangements, outlining the rights and obligations of each party.

Lending Policy and Procedures

Prudent purchases of loans, loan participations, and loan portfolios are governed by the credit principles and procedures embodied in the purchasing bank's formal lending policy. The policy ordinarily entails:

—complete analysis and documentation of the credit quality of obligations to be purchased;

—an analysis of the value and lien status of the collateral; and

—the maintenance of full credit information on the obligor during the term of the loan.

Independent Credit Analysis

To make a prudent credit decision, a purchaser contends an independent credit analysis to satisfy itself that a loan, loan participation, or loan portfolio is a credit which it would make directly. The nature and extent of the independent analysis is a function of the type of transaction at issue and the purchaser's lending policies and procedures. Where loans are purchased in bulk, for example, a prudent purchaser might assess the credit of the class of obligors rather than each obligor. *See generally Comptroller's Handbook for National Bank Examiners* at § 205 (guidelines on loan portfolio management).

The acceptance by a purchaser of a favorable analysis of a loan issued by the seller, a credit rating institution, or another entity does not satisfy the need to conduct an independent credit analysis. A prudent purchaser may, however, consider such analysis obtained from the seller and other sources as factors when independently assessing a loan.

A prudent purchaser needs full credit information on an obligor before a loan or participation is purchased to make an informed and independent evaluation of the credit. After the purchase is made, the purchaser also needs timely credit information to monitor the status of the credit. Such information can

often be obtained from the seller. In some situations, however, the purchaser may be unable to conduct an informed and independent analysis with information furnished by the selling or servicing bank. In such cases, other sources of information are needed to conduct an independent credit analysis.

Transfers of Credit Information

(a) *Prudent Transfer Agreements*. The indirect relationship between the obligor and the purchaser makes it difficult for the purchaser to assess the quality of the loan without the cooperation of the selling or servicing bank. The purchaser ordinarily needs to obtain full credit information on the obligor from the selling or servicing bank at the outset and during the life of the participation to perform a continuing independent assessment of the credit. Thus, a prudent purchase or participation document would generally include an agreement by the selling or servicing bank to provide available credit information on the obligor to the purchasing bank on a continuing basis. To ensure that full credit information will be available to the seller, a loan document would ordinarily include an agreement by the obligor to furnish such information to the seller on a continuing basis.[3]

The absence of prudent transfer agreements may affect a purchaser's ability to obtain, assess, and maintain sufficient credit information. Accordingly, the purchase of loan or participation absent such transfer obligations may be viewed as an unsafe or unsound banking practice.

(b) *Scope of prudent transfers*. Prudent transfers of credit information are sufficient in scope so as to enable a purchaser to make an informed and independent credit decision. Thus, prudent transfers encompass full and timely[4] financial and non-

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3 The Office does not intend to suggest that existing loan and participation agreements be renegotiated where full credit information is being furnished. Nonetheless, the Office may take appropriate action in any case where less than full credit information is obtained.

4 References to "full" and "timely" transfers of credit information are made herein to provide supervisory guidelines on safe and sound transfers of credit information. The guidelines describe the scope of transfers required for a purchaser to make an informed and independent credit decision. Apart from

financial information bearing on the quality of a loan. Financial information ordinarily includes:

—accrual status;

—status of principal and interest payments;

—financial statements, collateral values, and lien status; and

—any factual information bearing on the continuing creditworthiness of the obligor.

Prudent transfers also include nonfinancial information bearing on creditworthiness. For example, any known changes in the obligor's corporate structure or management affecting the quality of a loan would generally be disclosed.

Ordinarily, full credit information is obtained on each obligor. Where loans are purchased in bulk, however, a prudent purchaser might obtain credit information on the class of obligors rather than each obligor.

Prudent transfers of full credit information do not encompass the release of information in violation of law. In particular, loan classification information and other examiner opinions are set forth in confidential reports of examination and documents relating thereto. Such materials and information derived from them may not be disclosed absent express written approval by the Comptroller of the Currency pursuant to 12 C.F.R. § 4.18(c). Unauthorized disclosures may also incur criminal penalties under 18 U.S.C. § 641. In contrast, the facts underlying examiners' loan criticisms would generally be furnished, a knowing misrepresentation of credit quality may constitute a violation of 18 U.S.C. § 1014.

Recourse Arrangements

Repurchase agreements are subject to the limitations of 12 U.S.C. § 84. Other direct or indirect recourse arrangements, written or oral, provided by the selling bank will be considered

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such supervisory considerations, use of the terms "full" and "timely" is not intended to suggest that the terms have particular legal significance; thus, other terms may be used. The drafting and negotiation of standards governing transfers of credit information is the responsibility of bank management and counsel.

as extensions of credit to the selling bank subject to 12 U.S.C. § 84. *See* 12 C.F.R. §§ 32.104 and 32.107.

Prudent recourse arrangements are documented in writing and reflected on the books and records of both the buying and selling bank. The failure to properly record or document these arrangements may constitute a false entry, statement, report or representation in violation of 18 U.S.C. § 1005.

Questions regarding this banking circular may be directed to the Chief National Bank Examiner's Office, Commercial Examinations Division (202) 447-1165, and to the Legal Advisory Services Division (202) 447-1880.

Information Responsive to Rule 29.1

Petitioners' subsidiaries for purposes of Rule 29.1 are as follows:

Petitioner Banco Espanol de Credito: Banco Catala de Credit, S.A., Banco de Desarrollo Economico Espanol, S.A., Banco de Madrid, S.A., Banco de Vitoria, S.A., Banesto Consumo, S.A., Banesto Industrial Investment, Ltd., Banesto Lombardia y Lacai, S.A., S.V.B., Corporation Industrial y Financiera de Banesto, S.A., Financiera Finaval, S.A., Gesdinder, S.A. Sociedad Gestora de I.I.C., Gestisa Baer, S.A. S.G.C., Sodrepo, S.A., Union de Bancos de Uruguay.

Petitioner Banesto Banking Corporation: None within the meaning of Rule 29.1 of the Rules of the Supreme Court of the United States.

Petitioner Banco Totta & Acores: Sociedade de Promoção Imobiliària, S.A., Fundiários, S.A., Companhia Imobiliària Portuguesa, S.A., Sociedade de Aluguer de Veículos, S.A., Sociedade de Gestao de Patrimónios, S.A., Sociedade de Gestão do Fundo de Tesouraria Atlantica, S.A., Sociedade de Locação Financeira Imobiliária, S.A., Sociedade Internacional de Aquisição de Créditos, S.A., Sociedade Financeira, S.A., Sociedade Mediadora de Capitais, S.A.

Petitioner GiroCredit Bank: Bank-und Industrieunternehmen Holding Ges. m.b.h., Bevasarlopark Budapest KPT (Einkaufszentrum Budapest ges.m.b.H), Consultco International Projektierung u. Koordination von Bauten und Anlagan Ges.m.b.H., DONAU Allgemeine Versicherungs AG, E-C-A Holding Ges.m.b.H, Erste Wiener Hotel AG, ECD-Holdinggs m.b.H., Freshtainer Holding Company Ltd., Jersey, First Liechtenstein Investment Fonds Verwaltungs-AG, Gartenbau-Grundstucksverwertung AG, GEP Planung und Errichtung von Kleinkraftwerken AG, Gesellschaft fur energie-und umwelttechnische Projekte Ges.m.b.H., GiroCredit Investment (Budapest) AG, GiroCredit Mergers & Acquisitions Unternehmensberatung AG, Wien, Hans Jenewein, Hotelier, Alpbach, Hotel

Ananas-Hotelbetriebsges.m.b.H & Co. KG, Hotel Europa-Graz Gesellschaft m.b.H., Holzl Hotelbetriebsges.m.b.H, Hotelerrichtungsgesellschaft Knittelfeld Ges.m.b.H., HEVIZ Kur- und Sportzentrum AG, Wien, Industriegrundstucksverwaltungsges.m.b.H., Intermarket Factoring AG, "IMMO-RENT" Liegenschaftsanlage und Verwaltung Ges.m.b.H., IGM Robotersysteme AG, IMS-Ionen-Mikrofabrikationssysteme Ges.m.b.H., IMMORENT-SOBEK Grund-verwertungsges.m.b.H., IPC-International Pension Consultants Ges.m.b.H., ISVN-Versicherungsholding Ges.m.b.H., JOMI Unternehmensbeteiligunsges.m.b.H., Eybl Krems Textilwerke AG, Leasfinanz Vermietung von Investitionsgutern Ges.m.b.H. & Co. KG, Logrin AG, Mazda Austria Ges.m.b.H., Mazda Bank AG, MIJO Unternehmensbeteiligungsges.m.b.H., NOBG-Vermögensverwaltungsges.m.b.H. Niederosterreichischekreditburgschaftsges.m.b.H.,OHPT-Vermogensverwaltungsges.m.b.H., OKB-Vermogensverwaltungs-und Beteiligungsges.m.b.H., Osterreichische Verkehrsburo AG, OEVKB Holding Ges.m.b.H., OCI Unternehm-ensbetei-ligungsges.m.b.H., Osterr. Credit-Institut Unternehmensberatungsges.m.b.H., PCC-Hoteleinrichtungs-und Betriebsges.m.b.H. & Co. KG, Pinkafelder Sparund Kreditbank AG, "Philips" Mietfinanzierungsges. m.b.h., PRISMA Holding Ges.m.b.H., PHGZ Immobilien Ges.m.b.h., PODVIS Ges.m.b.H., Bulgarien, Real-Service-Realitat-envermittlungsges.m.b.H., Reiseburo Vindobona Hotelbetriebsges.m.b.H. & Co. KG Hotel Corvinus, RSV Beteiligungs-Ges.m.b.H., Realia Immobilien-Verwertungs AG, Sparund Kreditbank Pinkafeld-Rechnitz AG, Sparinvest Kapitalanlage AG, Sparkassen-Immobilienanlagen AG, Sparkassen-Versicherung AG, SPF-"Spar-Finanz"-Investitions-und-Vermittlungs-Ges.m.b.H., SPK-BF Holdingges.m.b.H., Steiermarkische Bank Ges.m.b.H., "Spar Finanz"-Investition-und Vermittlungs-AG, Sparkassen-Passage Linz Ges.m.b.H., S-Pensionskassen AG, S-Wohnbau Ges.m.b.H., Sparkasse Kremstal-Phyrn Ag, Sparkasse Bregenz, Tiefkuhlwaren-Marketingges. m.b.H., Tiroler Zollfreizone Betriebsges.m.b.H. Unzmarketer Kleinkraftwerke AG, WIGOS Ges.m.b.H., Bulgarien, Zentrum Metropole St. Polten, Errichtungs-und Betriebsges.m.b.H.

Petitioner Harmony Gold Ltd. HK: None within the meaning of Rule 29.1 of the Rules of the Supreme Court of the United States.

Petitioner International Commercial Bank of China: Chinese American Bank

Petitioner Monroe Bank & Trust: None within the meaning of Rule 29.1 of the Rules of the Supreme Court of the United States.

Petitioner Phelps Dodge Corporation: Alambres Y Cables de Panama, S.A., Alambres Y Cables Venezolanos, C.A., ALCAP Commercial, S.A., Bisbee Queen Mining Company, Cables Electricos Ecuatorianos, C.A, Cahosa, S.A., Celbac, S.A., Cobre Cerrillos, S.A., Cocesa Ingenieria Y Construccion, S.A., Columbian Carbon Japan Ltd., Columbian Carbon Philippines, Inc., Comercial ECOHSA, S.A. de C.V., CONDUCEN, S.A., CONDUCOMER, S.A. (formerly Industria de Electrocoductores, S.A.), Conductores Electricos de Centro America, S.A., Corporation Venezolana del Cobre, C.A., Electoconductores de Honduras, S.A. de C.V., Fabrica de Conductores Electricos, S.A., Phelps Dodge Outokumpu Copper OY International, Phelps Dodge Thailand Limited, Pietersburg Iron Company (Proprietary) Limited, Representaciones de Industrias Venezolanas, C.A., SPD Magnet Wire Co., South Australian Uranium Corporation Pty. Limited.

Petitioner Atlantic Richfield Company: AM/PM Comestiveis Ltda., ARCO Chemical (Malaysia) SDN, BHD., ARCO Chemical (Singapore) (PTE), Ltd., ARCO Chemical Bahamas, Ltd., ARCO Chemical Company, ARCO/JSP de Mexico, ARCO-BRASIL Participacoes e Investimentos Ltda., Atlantic Richfield Kalosi Ltd., 85819 Canada Limited, Chiunglong Petrochemical Co., Ltd., Greater Pacific Ltd., Kuparuk Transportation Capital Corp., Logan Aluminum, Inc., PAO & Etc. Industria y Comercio de Alimentos LTDA., PT Gema Polytama Kimia, A.C.E. Insurance Company, Ltd., A.C.E. Insurance Company (Bermuda), Ltd., Alyeska Pipeline Service Co., ARCO Solar Nigeria Ltd., Badger Pipe Line Co., Black Lake Pipe Line Co.,

Blair Athol Coal Pty., Ltd., Colonial Pipeline Co., Cook Inlet Pipe Line Co., Dalrymple Bay Coal Terminal Pty., Ltd., Dixie Pipeline Co., East Heidelberg Salt Water Disposal Co., East Texas Salt Water Disposal Co., Empresa de Transportes Jober Ltda., Empresas Lanzagorta, S.A. de. C.V., Enarco Resins S.P.A., International Tanker Indemnity Association, Ltd., Iricon Agency Ltd., Kenai Pipe Line Co., Lyondell Petrochemical Corp., MTC ARCO, Inc., Nihon Oxirane Co., Ltd., Nordisk Mineselskab A/S, Oil Casualty Insurance Ltd., Oil Insurance Ltd., Olympic Pipe Line Co., Platte Pipe Line Co., Tecumseh Pipe Line Co., Texas-New Mexico Pipe Line Co., Traansbase S/A, Transac S.A.-Transporte Rodoviario, Transcola S.A., Transcom-Transporte Combustivel S/A, Transka S.A.-Transportes, Translini S.A., Transportadora Andrade S/A, Transportadora Aparecida do Norte S/A, Transportes Brios S/A, Yukong Arco Chemical Ltd.,

Petitioners' parent companies for purposes of Rule 29.1 are as follows:

Petitioner Banesto Banking Corporation: Banco Espanol de Credito

Petitioner Girocredit Bank: Alligos Holding fur die Girozentrale AG and Z-Landerbank Bank Austria AG